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The Case Against Income Averaging

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THE CASE AGAINST INCOME AVERAGING

*Neil H. Buchanan**

Should tax liability be based on annual income or on the average of a taxpayer's income earned over the space of several years (or even a lifetime)? This article assesses proposals to replace the current method of computing taxes with a system that would allow taxpayers to smooth out their income tax liabilities by offsetting high-income years with low-income years. While the usual discussion of this issue revolves around supposed horizontal inequities, I show that it is not clear that the current system generates horizontal inequities at all; and even if it does, I suggest as a normative issue that these horizontal inequities alone are not sufficiently important to justify a change in the method of computing tax liability.

Looked at from a vertical equity perspective, however, I note that income averaging targeted toward lower income earners can be a helpful way to provide relief to workers who have uneven earnings patterns. I thus endorse a very limited averaging plan that would apply to the working poor and near-poor, allowing them to reduce their federal tax liability and to avoid losing EITC benefits due to temporary swings in income.

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I. INTRODUCTION

The topic of fundamental tax reform recently made a brief reappearance on the political agenda. In November 2005, a report was issued by a presidential panel that had been created specifically to recommend a path toward a better tax system.[1] Although the panel's report thus far seems not to be generating political action, the very fact that a highly respected group of scholars and policymakers was asked to weigh in on the topic attests to the enduring importance of the issue.[2] We can be confident that, even if the panel's proposals are not adopted in their current form, the pervasive dissatisfaction with our current tax system that led to the creation of the panel in the first place will continue to fester and lead to future proposals for reforms large and small.

While most tax reform discussions have revolved around proposals for changing the current federal income tax system into some form of a consumption tax (a national sales tax, the so-called Flat Tax, a value-added tax, etc.),[3] it is important also to consider whether it is possible to enact reforms that would preserve the traditional income tax base yet improve upon our current system –

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[1] PRESIDENT'S ADVISORY PANEL ON FED. TAX REFORM, SIMPLE, FAIR & PRO-GROWTH: PROPOSALS TO FIX AMERICA'S TAX SYSTEM (2005), *available at* http://www.taxreformpanel.gov/final-report/.

[2] The panel's tax proposals are receiving at least some attention from Congress. The first hearing on the panel report was held in February 2006. *See Transforming the Tax Code: An Examination of the President's Tax Reform Panel Recommendations: Hearing Before the Subcomm. on Tax, Finance, and Exports and Rural Enterprises, Agriculture and Technology of the H. Small Business Comm.*, 109th Cong. (2006). The prospects for any real action on the proposals are, of course, debatable. *See, e.g.*, *Senate's Top Democratic Tax Writer Declares Tax Reform Report 'Dead,'* ABERDEEN AM. NEWS, Feb. 8, 2006, *available at* 2006 WLNR 2171894 ("The Senate's top Democratic tax writer said Tuesday that a presidentially appointed panel's recommendations for overhauling tax laws don't stand a chance in Congress.").

[3] *See, e.g.*, John K. McNulty, *Flat Tax, Consumption Tax, Consumption-Type Income Tax Proposals in the United States: A Tax Policy Discussion of Fundamental Tax Reform*, 88 CAL. L. REV. 2095 (2000).

and most importantly, that would maintain and enhance the redistributive role served by the current income tax. A proposal long advocated by the late Columbia University economics professor William Vickrey known as "cumulative averaging" (or "income averaging," or simply "averaging") might be one such system. Vickrey argued that his system would tax income in a more accurate sense than the current tax system does, offering a possible alternative to the array of consumption tax proposals in policy debates over fundamental tax reform.[4]

The current U.S. personal income tax, which assesses taxes on an annual basis in a system with graduated tax rates, contains within it the potential for unequal treatment, imposing different amounts of tax liability based on the volatility or smoothness of taxpayers' earnings streams. A taxpayer who earns large amounts of income in one year and low amounts in other years might pay significantly more total tax over those years than another person who earns the same total amount of income but whose annual income is relatively constant. In other words, two people who earn equal amounts of income over the space of years can be treated quite differently by our tax system. The fundamental appeal of taxing average income is that it can address this potential inequity.

All inequities are not created equal, however. No system is perfect, and any particular imperfection is only worthy of our attention — and the expenditure of effort to enact new policies — if its continued existence meaningfully compromises important values or goals of society. This article, therefore, takes an approach that is to my knowledge unique in the literature on income averaging. Most importantly, I ask whether we should even be concerned about the possible inequity that averaging would mitigate — if, indeed, it is truly an inequity at all. I conclude that we should not, except for a very limited part of the problem that affects lower-income Americans and that could be fixed by a rather straightforward, very limited form of income averaging.

Before embarking on the analysis that leads to my endorsement of limited income averaging, I first discuss in quite basic terms the purposes of a tax system from the standpoint of society and the democratic system. I do so at some length to ground the discussion of tax inequities in the realm of social goals rather than in the abstract design of tax systems.

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[4] *See infra* Part II.B for a description of the mechanics of Vickrey's cumulative averaging system.

I then devote the third Part of this article to a description of the concept of income averaging, summarizing the use of averaging mechanisms in the U.S. tax system, both past and present. I also review the rather thin (but very informative) tax policy literature on income averaging. To provide a starting point for policy analysis, I then describe Vickrey's proposal for a full-scale replacement of the current U.S. income tax system with a system that would — as a central organizing principle — levy tax on the basis of a taxpayer's average rather than annual income.

Because the purported problem that Vickrey identified was a matter of horizontal inequity — two taxpayers who seem to be alike in a meaningful way (i.e., having received the same amount of income over the course of their lives) are treated differently by the tax system — I begin the fourth Part of the article by directly confronting the moral case for redressing horizontal inequities in the tax system. That case turns out not to be especially compelling, in part because the supposed horizontal inequity is not as much a matter of treating similarly-situated taxpayers differently as it initially seems, and because the moral force behind the urge to correct horizontal inequities is somewhat surprisingly connected to the question of vertical inequity. Put simply, learning that we inadvertently treat two high-income (but similarly situated) people differently because of an unintended side effect of the tax system is not as worrying as learning that we treat two low-income (but otherwise similarly situated) people differently. The morality of horizontal inequity becomes more compelling as the life situations of the taxpayers in question become more worrisome.

This observation leads naturally to a direct discussion of progressivity, the social goal that has held greatest sway over U.S. tax policy for the last century. While volumes have been written about progressivity in tax policy, I briefly summarize here only those arguments based on utilitarian assessments of inequality, Rawlsian concerns with the least well-off members of society, and Judeo-Christian ethics. The goal is to suggest that, even when thinking about a tax policy issue that appears to be a matter of possible horizontal inequity, the more important focus should be on how the tax system affects the least well-off members of society.

Assessing income averaging from the normative perspective described above, it turns out that much of the scholarly discussion about income averaging has focused on a purported inequity at the high end of the income spectrum: people who temporarily earn very high incomes due to short-term success pay annual taxes at the same rates as do people whose high incomes are a permanent part of their lives. Even if this implication of annual tax assessment is viewed as a horizontal inequity in the system — and, as noted, I offer reasons to believe that it might not be inequitable, even from a horizontal perspective — I argue that it is not a major policy concern. It might be somewhat unfortunate and would not exist in a perfect world, but it does not offend any serious egalitarian concern that should motivate tax reformers to take action.

For low-income earners, though, the concern raised by volatile earning streams can be very real and serious. Fortunately, the problems in this area can be addressed by a targeted system that allows the least well-paid workers to avoid the inequities in the current system.[5] This solution can be implemented, moreover, as a discrete policy measure rather than as part of a plan to completely rewrite the tax code or to change the basic accounting period on which the tax code is based.

Middle-income earners are, perhaps inevitably, a close call. I summarize some arguments for and against using an averaging system to help subsidize the temporary departure of secondary earners from the work force to take care of children and other family members, concluding that there are probably better ways to deal with child care needs and that, in any case, it is not clear whether those who do not leave the work force should pay higher taxes so that those who do leave temporarily can pay lower taxes. The system of limited averaging that I endorse can be extended upward into the middle class, of course, but it appears that the strongest case for averaging implies that we should aim our policy reforms at helping those low-income earners whose incomes are earned in fits and starts.

If equity is not meaningfully improved by adopting a tax system with income averaging available to all taxpayers, what of the other traditional goals of tax design: simplicity and efficiency? With so little to gain on the equity front, there needs to be a strong case indeed that generally available income averaging would simplify matters significantly or make the economy more efficient. Unfortunately, I conclude in the fifth Part of the article that even a conceptually simple averaging system is likely to be perceived as quite complicated and that it is also likely to create several problems that could increase the complexity of any real-world implementation of the system. In

[5] Specifically, I endorse the proposal outlined in Lily L. Batchelder, *Taxing the Poor: Income Averaging Reconsidered*, 40 HARV. J. ON LEGIS. 395 (2003), discussed in Part IV.D *infra*.

particular, an averaging system would create an additional opening for wasteful lobbying and tax planning that does not exist under an annual income tax system. Furthermore, the most important potential sources of simplification in Vickrey's system are not really based on averaging at all and could be adopted on their own. Adopting them separately from any plan for income averaging would, in fact, probably be the best approach.

The efficiency analysis turns up results that also fail to support the adoption of an averaging system for all taxpayers. After discussing the ambiguous results from standard efficiency analysis, I summarize a rather new and perhaps less familiar argument known as "winner-take-all markets" that is based on a unique efficiency concern that arises from the negative consequences of extreme income inequality. Because the race for high incomes can distort people's decisions about how to allocate their talents and efforts, I suggest that there might even be an efficiency gain from keeping the current system of annual taxation intact for temporary high earners, thus discouraging people from focusing inappropriately on professions that might offer one-shot gains that, by their very nature, can go only to the very lucky few.

I thus conclude that income averaging is not an appealing template for tax reform and, therefore, that taxes should continue to be computed on an annual basis. I would, however, allow lower income citizens to elect a simple plan that would mitigate arbitrary tax penalties that might otherwise flow from their uneven earnings patterns. Progressivity and simplicity should remain central concerns for tax reform, but income averaging (to say nothing of the full-scale program of fundamental tax reform with cumulative lifetime averaging that Vickrey recommended) is not a promising avenue toward either goal.

While I use Vickrey's proposal for cumulative income averaging as a starting point (and as something of a foil) in this article, the argument here is about much more than his particular — and particularly ambitious — averaging plan. The fundamental question is whether the tax consequences of uneven earnings patterns should be changed by adopting some form of generally-available income averaging procedure. I would offer a limited averaging plan as a tool to try to improve the lives of our least well-off citizens, but otherwise I conclude that the case for averaging fails on the grounds of equity, simplicity, and efficiency. In reaching that conclusion, I also fundamentally question the importance of horizontal equity as a primary concern of tax policy.

II. VICKREY, VALUES, AND TAX REFORM

A. In Memory of William Vickrey

In 1996, after a long and distinguished career as a public finance economist, William Vickrey was awarded the Bank of Sweden Prize in Economic Sciences in Memory of Alfred Nobel,[6] commonly known as the Nobel Prize in Economics.[7] Only a few days after learning that he had been selected for this honor, he died while driving to an economics conference.[8] He was thus prevented from receiving his prize in person and from enjoying the acclaim that would have come with the award.

Prior to his death (and several months prior to his recognition by the prize committee), I had the good fortune to speak privately with Professor Vickrey about his body of work.[9] During one conversation, I took the opportunity to ask him a straightforward question: "Do you wish that any of your work had had a greater impact than it has had?" His answer was simple: "Yes, cumulative averaging." He noted that

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[6] Vickrey shared the prize with James Mirrlees. Press Release, Royal Swedish Academy of Sciences, The Sveriges Riksbank (Bank of Sweden) Prize in Economic Sciences in Memory of Alfred Nobel for 1996 (Oct. 8, 1996), *available at* http://nobelprize.org/economics/laureates/1996/press.html (identifying Mirrlees and Vickrey each as winners of one-half of the prize "for their fundamental contributions to the economic theory of incentives under asymmetric information").

[7] While commonly used, this term is not strictly correct. The Nobel Prizes are separate and distinct from the economics award. The Nobel Prizes were first awarded in 1901 and are called "The Nobel Peace Prize" and "The Nobel Prize in ____" (Physics, Chemistry, Medicine, or Literature). *See, e.g.*, The Nobel Prize in Physics, http://nobelprize.org/physics. The economics award, on the other hand, was first awarded in 1969 and carries the somewhat ungainly name noted in the text. For a critique of the economics prize and an argument that the award should be abolished, see Barbara Bergmann, *Abolish the Nobel Prize for Economics — How Fair Is the Nobel?*, CHALLENGE, Mar.–Apr. 1999, at 52.

[8] Janny Scott, *After 3 Days in the Spotlight, Nobel Prize Winner is Dead*, N.Y. TIMES, Oct. 12, 1996, § 1, at 1.

[9] This truly was a matter of good fortune. I had not been one of Vickrey's students (indeed, my Ph.D. work was at Harvard rather than Columbia), nor was my dissertation focused on the design of the tax system. I was at that point a resident scholar at a small research institute, and I happened to meet Vickrey at a series of conferences. I do not, therefore, pretend to be uniquely situated to discuss Vickrey's "true views" or to have special insight into his mode of analysis. Rather, I took seriously the points that he made to me, took note of his obvious passion on the subject of his cumulative averaging system, and resolved that at some point I would give his proposal a careful look.

much of his earlier work no longer interested him and seemed rather trivial, such as his work on auction theory, which was later mentioned specifically in his award citation (and which is sometimes known by the eponymous term Vickrey Auctions).[10] Instead, he was most keenly interested in macroeconomic issues and government debt finance, especially as they related to the employment situation.[11]

Even so, Vickrey continued to be intensely concerned with the problem of tax reform. He spoke ruefully of the failure of the economics profession and the policy community to take up his cumulative averaging proposal, a proposal that he had first outlined more than fifty years earlier.[12] He provided me with a then-recent unpublished manuscript outlining his current thinking on the proposal.[13] While this later paper covered a wide range of subjects, cumulative averaging was the central policy proposal in that paper.

In a system of cumulative averaging, taxpayers would pay tax not on their annual income but on their cumulative average incomes over the course of their lifetimes. While I will outline the details of the full Vickrey plan further below,[14] it is helpful here to summarize the proposal very briefly. Vickrey's plan would tax about 90 percent of all taxpayers at a single rate, under what he called the "normal tax." The highest income taxpayers would pay an additional, progressive surtax.

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[10] Press Release, The Sveriges Riksbank (Bank of Sweden) Prize in Economic Sciences in Memory of Alfred Nobel for 1996 (Oct. 8, 1996), *available at* http://nobelprize.org/economics/laureates/1996/press.html (describing the work for which the winners of the prize were being honored, including Vickrey's work on auctions).

[11] William Vickrey, *Meaningfully Defining Deficits and Debt*, 82 AM. ECON. REV. 305, 308 (1992) ("At present, resources of both labor and productive capacity are woefully underutilized.").

[12] William Vickrey, *Averaging of Income for Income-Tax Purposes*, 47 J. POL. ECON. 379 (1939) [hereinafter Vickrey, *Averaging of Income 1939*]. The arguments in this article were expanded and included as a chapter in WILLIAM VICKREY, AGENDA FOR PROGRESSIVE TAXATION (1947) [hereinafter VICKREY, AGENDA 1947]. Vickrey further discusses these issues in his later works. *See* William Vickrey, *Tax Simplification Through Cumulative Averaging*, 34 LAW & CONTEMP. PROBS. 736 (1969); William Vickrey, *Cumulative Averaging After Thirty Years*, *in* MODERN FISCAL ISSUES: ESSAYS IN HONOR OF CARL S. SHOUP 117, 133 (Richard M. Bird and John G. Head eds., 1972) [hereinafter Vickrey, *After Thirty Years 1972*]; William Vickrey, *An Updated Agenda for Progressive Taxation*, 82 AM. ECON. REV. 257 (1992) [hereinafter Vickrey, *Updated Agenda 1992*]; William Vickrey, Simplification, Progression, and a Level Playing Field (Mar. 11, 1995) (unpublished manuscript, on file with author) [hereinafter Vickrey, Level Playing Field 1995].

[13] Vickrey, Level Playing Field 1995, *supra* note 12.

[14] *See infra* Part II.B.

Importantly, the surtax would be refundable if a person's subsequent earning went down, with taxes (or refunds) in any given year being determined by applying the tax rate schedule to each taxpayer's average lifetime income to date.

The focus in this article, however, is not on the full-scale Vickrey plan to replace the tax system entirely, but on the more limited (but still quite rich) question of whether any system that makes income averaging available to all taxpayers should be adopted in the United States. Despite my great respect for Professor Vickrey and his passionate advocacy of income averaging, I conclude that a general system of income averaging seems unnecessary to the achievement of either of his stated goals of progressivity or simplicity. I thus tentatively conclude that income averaging would not be a wise policy choice for the U.S. tax system, other than for low-income individuals.

B. The Goals and Effects of the Tax System

It is helpful here to return briefly to the fundamentals of tax analysis, recalling the uses and effects of taxes on society and our criteria in evaluating changes in the tax system. Because changing from an annual tax accounting system to a system of income averaging implicates these foundational issues, the starting point of analysis should be to recall what we expect the tax system to do and why.

The recent report by the president's tax reform commission[15] is only the latest event in an extended debate about the structure of the U.S. tax system. Each new election campaign, it seems, brings renewed calls to correct some fundamental flaw in the federal tax system.[16] We are promised that changes in the tax system will lead to greater simplicity, higher growth, enhanced international competitiveness, and a host of other appealing economic goals.[17] Clearly, though, these cannot be the only goals of tax reform — nor should they even be presumptively the central focus of analysis.

Because the tax system is one of the most potent tools at the disposal of any government, it should not be surprising that

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[15] *See supra* note 1.

[16] For a good description of the basic tax plans that have been floated in the United States over the last decade or so, see McNulty, *supra* note 3. Though published in 2000, McNulty's article still covers all of the relevant territory in terms of current tax reform proposals.

[17] The purported macroeconomic benefits of tax reform are discussed critically in Neil H. Buchanan, *Taxes, Saving, and Macroeconomics*, 33 J. ECON. ISSUES 59 (1999).

governments use the tax system to try to achieve social goals large and small. In the context of tax policy, no social ideal is more fundamental than the hard-to-define and shifting concept of fairness. "We have a procedure for deciding whether inequality is unjust, or how much is unjust. It is called democracy."[18] Faith in democracy is based in part on the belief that the people know best how to define the "good society." While the concept of the good society is constantly changing, some over-arching ideals can form the basis for evaluating any change in government policy. "The social processes of a free society are, if not infallible, the only reliable means to moral truth . . . ."[19]

Even on such strictly economic issues as the definitions of income and consumption and what should be taxed, the ethics of society and its definition of fairness not only define what is acceptable but define it differently in different situations. Unpaid labor provided at home, for example, has thus far not been defined as income for the purpose of calculating taxes, despite this being rather obviously a form of income.

A recent political debate in the state of Utah nicely illustrates the point. There, a politically conservative governor came into office in early 2005 and immediately put the issue of state tax reform on the table.[20] With the so-called Flat Tax being a favored policy by many conservatives, it appeared to some observers that a state-level flat tax was a "slam dunk."[21] Because a pure flat tax system has no charitable deductions, though, whereas the state's dominant Mormon church "reiterated its 'support of retaining a state tax deduction for charitable giving,'"[22] the political decision was clear: "There will not be a pure flat tax in Utah [because] a flat tax with no deductions, exemptions or credits simply does not reflect the values and priorities of Utahns."[23]

As the editorialist describing the Utah debate summed it up: "Here in Utah, good public policy is more than efficient policy. Good public policy will actually reflect the values and priorities of the people it serves."[24] One might well add that that is as true in every other state as it is in Utah. It cannot be otherwise. The relative

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[18] Herbert Stein, *Regarding Henry . . .*, WALL ST. J., Jan. 30, 1996, at A18.

[19] *Id.* (quoting Henry Simons without citation).

[20] Paul T. Mero, Editorial, *In Utah, the Flat Tax Doesn't Have a Prayer*, WALL ST. J., Oct. 27, 2005, at A21.

[21] *Id.*

[22] *Id.*

[23] *Id.*

[24] *Id.*

influence of different religious organizations, the variety of extant belief systems (religious and otherwise), and different personal and social priorities will lead to different outcomes in each debate, but the issues are always framed by a full range of social goals and moral concerns.

In this example, the values and priorities of the relevant population are evidently not driven by concerns about progressivity but about retaining the deduction for charitable contributions. Not all communities will give tax progressivity the primacy that I advocate here, but at least it is clear that moral values can and do strongly affect tax policy debates and the decisions that arise from those debates.

It is very much the point of policy analysis to scrutinize these social decisions and to suggest changes in the decisions that have been made (in many cases implicitly and without debate). Moreover, it would impoverish the analysis to start from the presumption that tax policy's only goals should revolve around those efficiency-related variables mentioned above (growth, international competitiveness, etc.).[25] Economic efficiency or prosperity cannot be the only goal of tax policy. If the people, through their elected representatives, choose to adopt a tax policy that is plainly inefficient, that is their right.[26]

In particular, it is *always* the case that changes in tax policy have the intended or unintended effect of changing society, that is, of being at least inadvertent acts of social engineering. Every definition of income, every exclusion, every attempt to simplify the tax system, involves choices as to what should be encouraged and what discouraged. In this broad sense, therefore, we cannot have a neutral tax system. The most honest way to evaluate proposed changes to a tax system is to ask two questions: (1) What are you trying to socially engineer? and (2) Are the trains running on time (i.e., are you a good engineer)?

This article looks at normative concepts of fairness in the tax code, as well as administrative efficiency (simplicity) and economic efficiency. Regarding fairness, I (like Vickrey) embrace the notion of

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[25] *See supra* note 17 and accompanying text.

[26] It is surely the case, in fact, that some of the most important public policy decisions in our history have been made without reference to efficiency concerns. An analysis of whether it was economically efficient to raise the national debt to fight World War II, which was fought against enemies that relied on private markets (the Axis powers of Germany, Italy, and Japan) and with an ally that promoted global communism (the Soviet Union) was never explicitly made, so far as I am aware. Fascism was viewed as wrong; and political and economic decisions flowed from that moral judgment.

progressivity. As discussed further below, it is always important to keep an eye on how the tax system affects the level of inequality in society. The focus is on normative analysis, specifically because I believe that normative concerns should be our first concern in any tax reform – and because income averaging so surprisingly fails to address serious normative concerns for all but the lowest income taxpayers.

C. Full-Scale Versus Limited Tax Reform

Vickrey's proposal would completely replace the current U.S tax system with his preferred ideal alternative. Full-scale plans for fundamental tax reform have been widely discussed for a number of years – though such plans are more often (but certainly not always) advanced by those on the conservative side of the political aisle.[27] Vickrey consciously advocated his cumulative averaging plan in the years immediately preceding his death as a progressive alternative to those plans: "[I]t is possible to achieve practical simplicity and a reduction in perverse incentives to a far greater degree than under any of the 'flat-rate' proposals being advanced, without significant sacrifice of progressivity."[28]

From this perspective, it is refreshing to consider a plan that directly attempts to separate simplicity from flatness or from changing the tax base. Vickrey makes the point that, for those who are willing to take the leap and completely rewrite the tax code, there are progressive alternatives. Indeed, on a panel discussing "Tax Reform for Lower-Income Taxpayers" at the annual meetings of the American Association of Law Schools, I started my remarks by saying: "I am here to advocate something that I do not actually believe in."[29] Explaining this seemingly self-negating statement, I suggested that – even for one who is highly skeptical of the wisdom of all-at-once tax reform – one could at least offer Vickrey's plan *arguendo*, as something to put on the table, should large-scale reform

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[27] Two articles summarizing some of the politically prominent plans in the 1990s, both of which criticize the plans themselves and question the wisdom of such root-and-branch approaches to tax reform, are McNulty, *supra* note 3, and Neil H. Buchanan, *A User's Guide to Proposals to Replace the U.S. Tax System and Strangle Fiscal Policy*, 33 J. ECON. ISSUES 505 (1999) [hereinafter Buchanan, *User's Guide*].

[28] Vickrey, Level Playing Field 1995, *supra* note 12, at 1.

[29] Neil H. Buchanan, Progressive Income Taxation and the Vickrey Cumulative Averaging System (Jan. 5, 2005) (unpublished manuscript, on file with author, presented at Association of American Law Schools annual meeting in San Francisco on January 5, 2005), and notes on file with author.

become politically possible.

Ultimately, though, it is almost surely true that Vickrey's full-scale plan for "[l]ifetime taxation is not a practical proposal."[30] Moreover, as I have argued elsewhere, even if a pure system were put in place, it would take no time at all for the system to be amended and altered, perhaps beyond recognition.[31] Talk of fundamental reform is intellectually engaging, but at some point it becomes more important to discuss realistic reforms. The remainder of this article, therefore, is concerned not with Vickrey's proposal as a possible political platform for a future presidential candidate but with income averaging as a method to redress arguable inequities in the tax system.

III. TAXING AVERAGE INCOME

As noted above,[32] the adoption of an annual system of tax accounting inherently runs the risk of creating arbitrary and thus horizontally inequitable results. Specifically, the problem flows from the interaction of annual accounting periods with graduated rate structures, potentially causing a taxpayer to pay a "tax penalty" (i.e., higher taxes than otherwise) merely because of the timing of his income stream over the space of a few years. This potential problem has long been recognized. In his landmark 1939 article, Vickrey could fairly begin by noting that "[i]t has *long been considered* one of the principal defects of the graduated individual income tax that fluctuating incomes are . . . subjected to much heavier tax burdens."[33]

Schmalbeck[34] and Batchelder[35] provide stylized examples of the consequences of being pushed into higher tax brackets temporarily. Using rates and deductions relevant to the time when each article was written, each provides examples that show that the penalty associated with volatile income can be very large (Schmalbeck, showing that a middle-income taxpayer can pay nearly sixty percent more in tax due to income volatility than she would have paid otherwise)[36] or quite low (Batchelder, showing a high-income taxpayer whose penalty from having volatile income is to pay a one percent increase in her average

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[30] Batchelder, *supra* note 5, at 416.

[31] Buchanan, *User's Guide*, *supra* note 27.

[32] *See supra* pages preceding Part II.A.

[33] Vickrey, *Averaging of Income 1939*, *supra* note 12, at 379 (emphasis added).

[34] Richard Schmalbeck, *Income Averaging After Twenty Years: A Failed Experiment in Horizontal Equity*, 1984 DUKE L.J. 509, 510.

[35] Batchelder, *supra* note 5, at 406.

[36] Schmalbeck, *supra* note 34, at 510.

tax rate).[37] Generating yet another such example here is beside the point, so long as it is understood that a graduated rate structure can have the effect of raising the total taxes paid by a taxpayer depending on how smoothly her income stream is earned.

In Part III.A below, I describe the U.S. experience with income averaging and the scholarly literature that has addressed the issue. Part III.B then describes the full-scale cumulative averaging plan that Professor Vickrey described in his 1995 manuscript.[38] After delving into those details, Part III.C considers Vickrey's plan not *in toto*, but by looking at the elements of the plan that are not necessarily logically connected to income averaging. It turns out that one could achieve many of Vickrey's apparent goals without necessarily endorsing the core of his cumulative averaging income tax system.

A. Averaging in Practice and in the Scholarly Literature

Any system that bases its tax assessments on a finite accounting period might generate results that seem arbitrary, because the economic activity that is taxed continues across the arbitrary boundary lines of time created by the tax system. When rates change from year to year, of course, the results might be still more arbitrary. This fundamental issue is, therefore, hardly a modern creation or discovery. Almost as soon as an arbitrary line is drawn, we will be confronted with the consequences of policing such a line.

Shortly after the adoption of the original Internal Revenue Code (Code), the U.S. Supreme Court was asked to address an unintended consequence of annual accounting. In *Burnet v. Sanford & Brooks Co.*,[39] the Court considered the case of a taxpayer who had lost money in several years and later recovered through suit an amount in excess of its previous losses. The taxpayer contended that, in essence, the U.S. income tax system was intended to impose taxes on profitable transactions of companies, not on annual profits. By that logic, the company should have been allowed to go back in time and offset gains in one year with losses in another, so long as the gains and losses were related to the same transaction. Rejecting that argument, the Court stated that, even if the net result of combining two years into a single taxable period would show a loss for the company, "it has never been

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[37] Batchelder, *supra* note 5, at 406 (referring to *id.* at 405 tbl.1, which demonstrates a one percent increase in the taxpayer's average tax rate due to having earned $200,000 one year and $100,000 the next, rather than $150,000 each year).

[38] Vickrey, Level Playing Field 1995, *supra* note 12.

[39] 282 U.S. 359 (1931).

supposed that that fact would relieve him of tax on the first [year's income], or that it affords any reason for postponing the assessment of the tax until the end of a lifetime, or for some other indefinite period."[40] Since the Congress that enacted the tax code was aware that the common practice in income tax systems was to tax on an annual basis, the Court could not conclude that Congress intended otherwise when it created an income tax for the United States.[41]

Since *Sanford & Brooks* was decided, Congress has taken up the Court's invitation and attempted to mitigate the effects of annual accounting in a number of *ad hoc* ways, a few of which I summarize here.

1. Attempts to Create Limited Relief in the Code

The current tax code includes several provisions that break with the logic enunciated in *Sanford & Brooks* by allowing taxpayers to take advantage of losses in one year to offset gains in another. Section 172 allows individual taxpayers to carry forward or carry backward net operating losses of a business (for twenty years and two years, respectively).[42] This section was created to "ameliorate the unduly drastic consequences of taxing income strictly on an annual basis."[43] Capital losses may also be carried over.[44]

The "tax benefit rule" allows a taxpayer who has not taken advantage of a tax deduction (and can no longer do so) to avoid paying taxes on a subsequent recovery.[45] This rule is highly incomplete in providing relief, however, because it only protects taxpayers who have received zero benefit from a deduction. If a taxpayer has received any reduction at all in taxes due in one year, it could still be required to pay taxes at a higher rate in a subsequent year.[46]

These limited examples demonstrate that Congress has not systematically undermined the basic annual accounting framework in the current tax code. At one point, however, Congress did enact a system of limited income averaging.[47] Richard Schmalbeck's

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[40] *Id.* at 365.

[41] *Id.*

[42] I.R.C. § 172.

[43] United States v. Foster Lumber Co., 429 U.S. 32, 42 (1976).

[44] I.R.C. § 1212.

[45] I.R.C. § 111.

[46] WILLIAM A. KLEIN ET AL., FEDERAL INCOME TAXATION 139 (14th ed. 2006).

[47] I.R.C. §§ 1301–05 (1954) (repealed 1986).

landmark article discussing that ill-fated system was actually written in advance of the law's repeal,[48] though the question of whether his article was the direct cause of the law's demise is certainly open to speculation. Schmalbeck describes the various provisions of the now-repealed averaging system in admirable (one might even say excruciating) detail, noting *inter alia* that the system was originally set up to allow taxpayers to average income over the previous four years[49] (later reduced to three years[50]) and that the system did not permit taxpayers to take advantage of averaging when income declined.[51]

As Schmalbeck notes, though, "it is extremely difficult to describe the income averaging computations accurately without falling into the soporific syntax of the instructions found on tax forms: Take the excess of this over twice the amount of that, and multiply the result by some other apparently arbitrary amount."[52] Learning now whether, for example, nonresident aliens were eligible to elect income averaging[53] would serve as an unnecessary distraction. Fortunately, it is necessary to note here only that the system that existed from 1964 to 1986 was clearly not the lifetime cumulative averaging system that Vickrey envisioned, nor was it a benchmark for any more generalized averaging system. It is worth noting, however, that our one major real-world attempt to introduce even a limited form of averaging for all taxpayers was quite messy and was ultimately repealed.

2. Vickrey and the Tax Policy Literature

As noted in the introduction to this article, Vickrey was deeply disappointed that his cumulative averaging proposal did not capture the imaginations of the academic and political communities. An article that he wrote a few years before his death began: "Since the publication of the *Agenda [for Progressive Taxation]* in 1947, remarkably little of its recommendations have seen implementation .... While many of the original recommendations

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[48] Schmalbeck, *supra* note 34.

[49] *Id.* at 510.

[50] *Id.* at 578.

[51] *Id.* at 510 (stating that the law defines "averagable income" as the amount by which taxable income in the computation year *exceeds* thirty percent of total income in the base period); *id.* at 577 (arguing that "Congress should ... make averaging available when a taxpayer's income declines").

[52] *Id.* at 512.

[53] *Id.* at 519 (they were not eligible).

remain valid, new circumstances call for a fresh look."[54]

Vickrey's assessment of his proposal's unpopularity appears to have been largely accurate. As Batchelder notes: "Few scholars have systematically analyzed the merits of taxation of lifetime income relative to the annual perspective," noting only two such pieces over the previous fifty years.[55] Even broadening a search in the legal literature[56] to find articles that refer to Vickrey's landmark 1939 article on cumulative averaging[57] or to his 1947 book on progressive taxation[58] reveals a relatively small number of citations. Moreover, these citations to Vickrey's work often refer to some other topic entirely,[59] mention averaging briefly in the context of discussing a related topic,[60] or contrast it with the subject of the author's interest.[61]

The commentators who deal most directly with the essence of Vickrey's approach include Soled, who argues for a two-year period of taxation, rather than one,[62] Shakow, who discusses cumulative

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[54] Vickrey, *Updated Agenda 1992*, *supra* note 12, at 257.

[55] Batchelder, *supra* note 5, at 399 (citing Schmalbeck, *supra* note 34, and Wilbur A. Steger, *On the Theoretical Equity of an Averaging Concept for Income Tax Purposes*, 13 TAX L. REV. 211 (1958)).

[56] The search was limited by the coverage of the database to articles published since 1980.

[57] Ten articles cited Vickrey, *Averaging of Income 1939*, *supra* note 12. The full list is on file with the author. Individual articles mentioned in the text are footnoted below.

[58] Forty-six articles cited VICKREY, AGENDA 1947, *supra* note 12. The full list is on file with the author. Individual articles mentioned in the text are footnoted below.

[59] *See, e.g.*, William T. Mathias, *Curtailing the Economic Distortions of the Mortgage Interest Deduction*, 30 U. MICH. J.L. REFORM 43, 54 (1996) (citing Vickrey for the proposition that "pure free-market economists argue that government preferences for home ownership lead citizens to divert resources from their most productive uses, thereby reducing economic efficiency and retarding economic growth").

[60] *See, e.g.*, Stephen B. Land, *Defeating Deferral: A Proposal for Retrospective Taxation*, 52 TAX L. REV. 45, 62–64 (1996) (referring to Vickrey's lifetime averaging system in the course of discussing "accrual on debt instruments"); *see also* David M. Schizer, *Realization As Subsidy*, 73 N.Y.U.L. REV. 1549, 1596–97 (1998) (mentioning Vickrey among a group of authors who have proposed charging interest on taxes deferred due to the realization requirement).

[61] Noël B. Cunningham, *Commentary Observations on Retrospective Taxation*, 53 TAX L. REV. 489, 490 n.16 (2000) (citing Vickrey's averaging plan as a method of retrospective taxation that is an alternative to "most methods," which "deal solely with assumed gains . . . ").

[62] Jay A. Soled, *A Proposal To Lengthen the Tax Accounting Period*, 14 AM. J. TAX POL'Y 35 (1997).

averaging at length in an article advocating accrual taxation,[63] Batchelder, whose work is discussed below,[64] and McCaffery, who spends several pages comparing and contrasting his proposal for a progressive postpaid consumption tax with Vickrey's cumulative averaging plan.[65]

In addition to these published works, several relevant unpublished articles have circulated recently. Liebman derives theoretical conditions under which cumulative taxation could increase social well-being.[66] Fennell and Stark offer a careful analysis of Vickrey's cumulative averaging proposal,[67] followed by their own alternative proposal of a system of "age-based taxation," which adjusts the tax rate structure to take account of age.[68]

Finally, Schlunk proposed a lifetime averaging system for a unique purpose: allowing taxpayers to borrow less money in private markets by shifting their borrowing to the government, which can borrow at lower rates. Thus, even if the taxpayers ultimately reimburse the government for its borrowing costs, they are better off by the amount of the lower interest payments.[69] While an interesting proposal, Schlunk's focus is clearly not on the same issues that motivated Vickrey.[70]

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[63] David J. Shakow, *Taxation Without Realization: A Proposal for Accrual Taxation*, 134 U. PA. L. REV. 1111 (1986).

[64] Batchelder, *supra* note 5, discussed *infra* Part V.

[65] Edward J. McCaffery, *A New Understanding of Tax*, 103 MICH. L. REV. 807, 880–84 (2005).

[66] Jeffrey Liebman, Should Taxes Be Based on Lifetime Income? Vickrey Taxation Revisited (Feb. 27, 2003) (unpublished manuscript, on file with author).

[67] Lee Anne Fennell & Kirk J. Stark, *Taxation Over Time*, 59 TAX L. REV. (forthcoming 2006) (manuscript at 23–32, on file with author), *available at* http://www.law.nyu.edu/colloquia/taxpolicy/papers/06/Lee_Fennell.pdf.

[68] *Id.* at 32–55. In particular, see *id.* at 32 ("Age-based taxes take an entirely different approach to the problem of taxation over time than do lifetime averaging proposals. Instead of seeking to effectively level out peaks and valleys in earning patterns, age-based taxes attempt to consciously exploit systemic life cycle patterns . . . .") and *id.* at 33 ("Our analysis focuses on a more fundamental alteration of the tax *rate* structure to take account of age.").

[69] Herwig J. Schlunk, *A Lifetime Income Tax* (Vanderbilt Univ. Law Sch. Law & Econ. Research Paper Series, Working Paper No. 05-07, 2005), *available at* http://ssrn.com/abstract=668942. In particular, see *id.* at 2–4.

[70] *Id.* at 30 ("This paper is not directly concerned with the detrimental effects that a progressive income tax regime can have on taxpaying units with wildly fluctuating incomes."). Schlunk does go on to examine an example of a taxpayer with a volatile income stream, but he concludes that the benefit from the government's lower-cost borrowing is likely to be more important even to a volatile-income

It thus seems fair to say that Vickrey was right in concluding that his plan for cumulative averaging garnered little support — and apparently no unqualified support — and that this situation continues to this day. Schmalbeck and Batchelder deal most centrally with the concept of income averaging in the sense that Vickrey discussed it, but each author rejects to a significant degree Vickrey's policy stance. The article that you are now reading, it is fair to say, also falls into that category.

B. The Vickrey Plan

In describing Vickrey's cumulative averaging proposal here, I do not identify specific tax rates or other institutional details, because those details are not the focus of this (or Vickrey's) analysis. For the occasional example, I use specific rates and other details only for illustrative purposes. I also focus on the personal tax side of Vickrey's system, not on the corporate side.

Under the Vickrey plan, the personal income tax system would have two parts. First, everyone would pay a "normal tax,"[71] which would be applied to all income below a maximum threshold at a single low rate.[72] The normal tax would be withheld from people's paychecks as well as from interest payments from banks, dividends on stock, etc.[73] This would not require the filing of any individual tax returns. People would tell their employer how many exemptions they qualify for (similar to the current form that everyone fills out on the first day in a new job),[74] but otherwise they would not have to deal personally with income taxes at all.

Vickrey suggested that the normal tax rate should be kept constant over time, "to avoid pesky problems as to which yearly rate should be applied to a given payment."[75] If the government needed to raise more revenue, it could change personal allowances or raise the surtax rate, which (as explained immediately below) is paid only by the highest-income taxpayers.[76]

The second part of the Vickrey system, the "surtax," is a progressive-rate tax system applied above a certain annual average

taxpayer than any benefits from smoothing tax liabilities. *See id.* at 35.

[71] Vickrey, Level Playing Field 1995, *supra* note 12, at 1.

[72] *Id.*

[73] *Id.* at 2.

[74] *Id.*

[75] *Id.*

[76] *Id.*

income level,[77] with the cutoff set so that it would apply only to about ten percent or less of taxpayers.[78] Vickrey argued that the additional record-keeping required by this system (compared to the current system) would be trivial, involving nothing more than carrying over cumulative lifetime income and taxes paid from the previous year's tax return to the current year.[79] The surtax would then be cumulative, such that taxpayers would only pay the surtax if their average income to date was above the cut-off point.

Importantly, the Vickrey surtax would be refundable, rebating taxes paid if a taxpayer's average income fell below the cut-off point.[80] In that way, the system acts like a "wage insurance" plan. For example, suppose that the average annual income cut-off for the surtax was $100,000. If a person earned $450,000 per year every year, then he or she would pay the surtax every year on $350,000 of income. But if the taxpayer earned $450,000 in year one and $50,000 every year after that, then they would not only pay no surtax after year one but would also receive a refund of part of the first year's surtax every year based on average income, until average income reached the cut-off point, which would mean that the taxpayer would have paid only ten percent of lifetime income in taxes. Vickrey argued that this system would be administratively much simpler than the current system for the vast majority of the population, that it would be progressive, and that it would smooth out swings in income.[81]

As noted, the focus of this article is not on the details of Vickrey's full-scale proposal but on income averaging alone, without the overlay of normal taxes and surtaxes or other details such as who must fill out income tax returns. Even so, it is worth noting that Vickrey's plan would apply a single rate under the normal tax system to ninety percent or more of all taxpayers.[82] If progressivity is good, why is it only good above a certain income level? It is certainly true that there are compelling arguments for having someone with income of $600,000 pay a higher rate than someone who makes $60,000,[83] but if

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[77] *Id.* at 4.

[78] *Id.*

[79] *Id.* at 5.

[80] *Id.*

[81] Vickrey, *Averaging of Income 1939*, *supra* note 12, at 397; Vickrey, Level Playing Field 1995, *supra* note 12, at 1.

[82] Vickrey, Level Playing Field 1995, *supra* note 12, at 4.

[83] The arguments here do not turn on whether we are discussing annual income or average income, so long as all numerical examples are understood to be measured consistently.

the income cut-off for the surtax were, say, $120,000 in Vickrey's system, why are we comfortable having someone with $120,000 in income pay tax at the same normal rate as someone with $40,000 in income? Especially because we are now thinking about much larger numbers of taxpayers, this seems an odd choice in that it would require lower-middle-class taxpayers to pay taxes at the same rate as those at the upper end of the middle-class.[84] Although I note below that the arguments for progressivity are less compelling with smaller income differences and that this might be a reason not to be particularly concerned about the inadvertent horizontal inequities potentially caused by an annual income tax system with progressive rates, it is nevertheless odd to think of designing a tax system deliberately from the start to be proportional over the vast majority of the population.

Vickrey's indirect response to this argument is that simplicity trumps progressivity: "The total number of returns to be processed by the IRS would be reduced by 60 to 80 percent."[85] While such tradeoffs are matters of judgment, it seems at least worth questioning the choice to simplify the system by taxing the near-poor and the upper middle class at the same rate. The idea of fewer people filling out tax forms is, of course, appealing, but at what cost to equity?[86]

C. Non-Averaging Aspects of Vickrey's Proposal

Vickrey's plan is interesting and certainly not often discussed in policy circles. Given that Vickrey put so much emphasis on the simplification that would be achieved by his system, though, it is notable that averaging is not what he identified as the principal source of simplification in his system. "The real simplification comes from the fact that the ultimate burden on the taxpayer is largely independent of the time at which he reports income."[87] Why?

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[84] *Cf.* Start Making Sense, http://danshaviro.blogspot.com/2005/06/aei-tax-reform-panel.html (June 7, 2005, 14:31 EST) (weblog entry by Daniel N. Shaviro, discussing proposal in Michael J. Graetz, *100 Million Unnecessary Returns: A Fresh Start for the U.S. Tax System*, 112 YALE L.J. 261 (2002), describing a "dilemma resulting from the basic tradeoff between good distributional results and low-end simplification").

[85] Vickrey, Level Playing Field 1995, *supra* note 12, at 4.

[86] On the other hand, it is at least true that a single rate in the normal tax range eliminates the penalty for income volatility within that range. Receiving taxable income of $100,000 one year and $50,000 the next would result in exactly the same tax payments as receiving $75,000 for both years.

[87] Vickrey, Level Playing Field 1995, *supra* note 12, at 5–6.

Because Vickrey would continue to allow taxpayers to defer tax payments on gains until realization events occurred, but they would be required to pay interest on the unpaid taxes. "Provided only that all income accruals (including capital gains and losses) are eventually brought to account . . . deferral of the realization or reporting of income becomes merely a borrowing of the corresponding tax at an appropriate rate of interest."[88] Vickrey even suggests that the rate of interest can become a policy tool, whereby lowering the rate at which taxpayers "borrow" their unpaid taxes from the government would act like a tax cut.[89]

Vickrey argued that, because of this "real simplification" of the tax system, "some two-thirds of the internal revenue code would become redundant."[90] This suggests that a large part of Vickrey's proposed benefits derive not from his normal tax/surtax arrangement nor from averaging income for tax purposes but from the requirement that nonrealized tax obligations be charged interest. This idea may well have merit, but it does not require anything as large-scale as Vickrey proposes — nor even the adoption of income averaging at all.[91]

Similarly, Vickrey proposes to improve the tax system by broadening the income tax base. As he notes, "it is necessary to eliminate many of the bells and whistles that confer benefits on selected constituencies, and to refrain from attempts to use the income tax as a device to encourage particular activities."[92] That is an outcome for which we can all fervently hope, but the advantage again comes not from income averaging nor from the normal tax/surtax approach. Instead, it would arise from a sudden onset of conscience, restraint, and responsibility on the part of Congress.

The larger point here is that the various elements of the Vickrey system are severable. Base broadening is appealing on its own merits. Better treatment of timing issues is appealing as well. Either or both can be enacted now or in the future, whether or not income averaging or the rest of the Vickrey package become part of the policy debate. This is fortunate, given that the analysis below ultimately rejects the income averaging aspect of Vickrey's proposal. While averaging

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[88] *Id.* at 3.

[89] *Id.* at 6.

[90] *Id.*

[91] Indeed, this is the context in which Schizer cited Vickrey. *See* Schizer, *supra* note 60, at 1596. Schizer points out that a number of other authors have proposed similar interest-charging approaches on unrealized gains.

[92] Vickrey, Level Playing Field 1995, *supra* note 12, at 1.

might have been the heart of the plan in Vickrey's view, that need not stop us from adopting appealing proposals that are severable from the whole plan and separate from income averaging.

IV. EQUITY AND INCOME AVERAGING

As noted earlier, one conclusion of this article is that the Vickrey system of cumulative income averaging is not a desirable alternative for tax reform. More generally, income averaging alone, even without the rest of the Vickrey apparatus, is not attractive except for the lower end of the income spectrum. I should note that I reached this conclusion somewhat by surprise. In 2004, when I reflected upon my earlier conversations with Professor Vickrey and decided to pursue his invitation to investigate cumulative averaging, I did so expecting to be an advocate of his proposal, not a critic. Indeed, as noted earlier, when I presented some preliminary thoughts that ultimately led to the writing of this article, I argued in favor of adopting a system of cumulative averaging in my presentation on the Tax Section panel at the annual meeting of the American Association of Law Schools.[93]

Despite this predisposition in favor of income averaging, it ultimately became clear that the arguments in favor of the system were either unconvincing or weaker than the arguments against it. As I argue below, the ultimate policy concern that cumulative averaging addresses (the unequal effective tax rates faced by those with volatile incomes, compared to those with stable incomes) is not sufficiently serious to justify a change in the basic method of computing taxable income.[94] The apparent horizontal inequity of such an outcome might seem somewhat regrettable when viewed in isolation, but as an argument for changing the accounting period used in our income tax system, it falls far short of compelling.

The issue in any tax reform, after all, is not: "How would we design a system from scratch?" but: "Given the trade-offs, is it worth trying to change the current system to achieve a specific goal or goals?" We are never writing on a blank slate. "[W]e never face issues of tax design, but rather always issues of tax reform."[95] Without a clear and compelling case that there is a basic injustice (or inefficiency, or some other important defect) in the current system

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[93] *See supra* note 29 and accompanying text.

[94] *See infra* Part IV.B, D.

[95] LIAM MURPHY & THOMAS NAGEL, THE MYTH OF OWNERSHIP 128 (2002) (paraphrasing Martin Feldstein, *On the Theory of Tax Reform*, 6 J. PUB. ECON. 77 (1976)).

that must be redressed, any problems of transition — and any complications in the design of the proposal itself — loom very large.

This should not, however, be read to impose on tax policy analysis a bias in favor of the status quo. It is true that any reasonable analyst should be careful to consider the transition and revenue considerations of tax policies, but these issues are surely not presumptively strong enough to inevitably overcome any other concerns — especially normative concerns — that are appropriately raised in a policy debate. My conclusions here are driven by the belief that our most appropriate policy concern should not be about people with high average incomes who happen to earn those incomes in a volatile fashion but about people at the bottom of society. A policy proposal that would improve the lives of those who most need it would have much to commend it, even when weighed against transition and revenue effects.

Therefore, this Part explains why the case that there is a fundamental injustice in the current system is relatively weak, as a threshold issue. I conclude that whatever merits might be associated with income averaging, there is ultimately not a strong case to adopt it for all taxpayers. Instead, a very limited averaging system for the lowest-earning taxpayers would address the most pressing normative concerns.[96] In the subsequent Part, I then describe some complications that would come with the adoption of income averaging, suggesting that even if we ignore the threshold issue of the desirability of cumulative averaging as an ethical matter, the system might become too complicated to be a viable alternative even to the current system, administratively and certainly politically.

A. Revenue Neutrality

To discipline the analysis, it is important to recall that any attempt to fix the perceived inequity of an annual tax accounting system will simultaneously affect tax revenues. If we allow people to average their incomes but we do not simultaneously change tax rates (or at least change some aspect of the Code that affects revenues, such as deductions and exclusions), those with volatile earnings will pay less in taxes, while those with smooth incomes will pay the same as they would have paid under annual taxation. The net result is a decline in annual tax revenues.

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[96] *See infra* Part IV.D, advocating the policy conclusions in Batchelder, *supra* note 5.

If we are willing to collect less revenue, though, we are acknowledging that we are currently collecting more income than we need. If so, then we should have decreased taxes in any case, even if there were no taxpayers at all who earned their incomes in an uneven pattern. The choice to decrease tax collections by adopting an averaging system, therefore, will prevent us from providing tax relief through any other means, such as reducing tax rates or offering targeted relief to other groups of taxpayers. Adopting an averaging system, therefore, would necessarily involve some taxpayers paying more tax than they would otherwise pay, even if we do not explicitly raise tax rates.

Suppose, though, that we did not think that we were collecting too little revenue before we discovered the problem that Vickrey identified, but we concluded that our new knowledge of the averaging-related inequity justified a decision to decrease tax collections and thus increase the fiscal deficit. This does not change the analysis, because we would still be saying that we are now willing to tolerate a higher fiscal deficit in order to provide tax relief to a certain group of taxpayers. We would still need to justify why it is the volatile earners who are at the top of the priority list in meriting tax relief.

The baseline assumption, therefore, in the analysis below is that any attempt to provide tax relief for volatile earners through adoption of a system of averaging must come at someone's expense. This is the familiar "revenue neutrality" assumption, whereby we assume that the amount of tax revenue currently being collected is the amount that we would like to collect, and any changes that reduce taxes in one part of the system must be balanced by changes elsewhere.

Perhaps the easiest way to conceptualize revenue neutrality is to assume that any targeted tax reductions will be offset by system-wide proportional increase in tax rates. If the targeted reduction is small, of course, then the increase in rates will not be large; but there must be at least some increase in rates. As I will discuss below, there are situations in which we could imagine making up the revenue through targeted increases, which would make broader increases unnecessary. For example, we could decide to give low-income volatile earners a break by raising rates on other low-income earners or by raising rates on higher-income earners. Making such choices raises both horizontal and vertical equity issues. The point, though, is that someone pays more when someone else pays less.

This approach might seem to put a rather strict conceptual straitjacket on any tax analysis. Imagine, for example, that instead of an arguable inequity such as the tax penalty on volatile income earners, we discovered that some obscure provisions buried in a recent tax bill had completely arbitrarily raised the tax bill for exactly one taxpayer. Surely, if we agreed that this citizen's higher tax burden was an error, we would readily agree to a technical correction to delete the offending provision of the tax code. Why complicate the analysis with talk of "tax increases" for other people?

Even in this extreme case, though, revenue neutrality provides the most sensible approach, because either we must make up for the decreased revenue elsewhere or we must do without. If we raise revenue elsewhere, we will do so because we believe that we all should share in alleviating the unfair burden mistakenly imposed on this one taxpayer. If we do without, we might well do so because we agree that purely unintentional tax penalties are perverse and should not be allowed — so, even if there are other high priorities for tax reductions, continued respect for the tax system will be undermined if we do not correct such purely arbitrary treatment. Either way, though, we must make choices about whether and how to respond to a perceived inequity.

Such a discussion, as noted, raises concerns of vertical as well as horizontal equity. In an attempt to isolate the horizontal equity issue, Liebman discusses a concept called "distributional neutrality," in which the adoption of a system of averaging would not shift tax burdens vertically but would continue to tax "everyone at a given level of lifetime income at the average of the lifetime tax currently paid by people at that level of lifetime income. [This] approach obviates the need to make judgements [sic] about the desirability of redistribution across lifetime income levels."[97]

While useful for Liebman's purposes, distributional neutrality is most definitely not appropriate as the basic standard for the discussion here. The point, after all, is to determine whether we want to change the system in response to an arguable inequity that might well affect only certain categories of taxpayers. If we learn that our failure to adopt averaging harms low-income people exclusively (or principally), then we might well want to fix that problem in a way that shifts the tax burden not onto other poor taxpayers but onto higher-income taxpayers. Indeed, I will argue explicitly for that outcome.

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[97] Liebman, *supra* note 66, at 25.

B. Horizontal Equity

Horizontal equity is the familiar requirement that we "treat likes alike." The intuition behind the goal of horizontal equity is quite powerful. Indeed, it is the basis for the reliance on precedent in judicial decision-making. If two people do the same thing but are treated differently, it had better be because they are somehow different.[98]

Of course, the role of a lawyer is to explore the contours of "like treatment" and who is "alike" in the first place. When Schmalbeck wrote that "[h]orizontal equity demands that taxpayers who have equal incomes be taxed equally,"[99] therefore, he overstated the case (or under-described the facts). It is not equal incomes alone that require equal taxation; and even if the issue were limited to equal incomes, that still leaves open the question that is fundamental to Vickrey's equity concern, i.e., incomes over what time period? As Schmalbeck went on to explain: "Definitions of horizontal equity are typically vague concerning the period over which it is to be gauged. The principle is simply that 'similarly situated people should be treated similarly, that equals should be treated equally.'"[100]

Vickrey argued, in fact, that we should care about horizontal inequity because of the ability-to-pay concept that is the essence of vertical equity. "It is an obvious extension of the principle of taxation according to ability to pay that no taxpayer should bear a heavier or lighter burden merely because certain items of his income happen to be earned or realized in one year or another."[101] As I will demonstrate below, this argument begs the question of whether uneven earnings streams should be viewed as "the same" as smooth earnings streams simply because they add up to the same total over time. Vickrey is correct, though, to suggest that the argument for horizontal equity in taxation gains moral force when it is tied to the arguments pertaining to vertical equity.

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[98] Even young children exhibit a strong sense of fairness based on horizontal equity. Siblings complain when other siblings are perceived to receive special treatment, such as being given a later bedtime at a similar age.

[99] Schmalbeck, *supra* note 34, at 509.

[100] *Id.* at 547 (quoting WILLIAM A. KLEIN, POLICY ANALYSIS OF THE FEDERAL INCOME TAX 7 (1976)).

[101] Vickrey, *Averaging of Income 1939*, *supra* note 12, at 381.

1. When is Averaging the Appropriate System of Taxation?

Suppose that a person knows that his or her job is secure and that the employer insists on paying alternately $20,000 one year and $180,000 the next, for the next forty years until retirement (with inflation adjustments). Clearly, people in such a position could be justified in viewing themselves as $100,000 per year earners. If the tax system penalizes this earnings pattern, of course, they would also be justified in asking their employer to change the pattern, but for present purposes we can assume that the employer refuses.

In this highly stylized case, what is necessary to view this earner as being "like" someone who earns $100,000 per year throughout their lifetime? The answer is not obvious, unless one simply asserts that multi-year analysis is the right way to view the situation and that the annual method is the wrong way. It is possible, after all, that people with volatile earnings do not view themselves as $100,000 per year earners and do not act as if they do. In the extreme, they might simply go from year to year, never noticing that their earnings pattern is predictable. In such a case, they can live well one year and badly the next. If they are sufficiently forward-looking, though, after an initial period of adjustment they could simply save in the good years and consume out of savings in the bad years, smoothing out consumption to mimic someone who earns approximately $100,000 each year.

This example is, of course, rigged to make it seem all but certain that even mildly rational people would soon treat themselves as earning $100,000 per year. What about a person who is likely to earn $20,000 for twenty years and $180,000 for the following twenty years? Even if they were so inclined, could they treat themselves as if they were earning their average income rather than their current income? Fennell and Stark note that "cognitive factors and capital market imperfections" will have important effects on the ability of such people to treat themselves as $100,000 per year earners.[102]

In general, the more cognitive biases a person exhibits (myopia, etc.), and the more incomplete and imperfect the financial markets are (e.g., some taxpayers being unable to get loans at nonusurious rates), the less likely they are to view lifetime income as relevant to their decision making — and the less important is the horizontal equity issue raised by volatile income streams. Schmalbeck concludes that "there are powerful arguments for the annual view. This is particularly the case in situations where the taxpayer does not

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[102] Fennell & Stark, *supra* note 67, at 31.

anticipate the change in income."[103]

In addition to the question of how volatile earners view themselves, there is the even more basic question of how many volatile earners there are. Fennell and Stark somewhat misstate the case when the say that "individuals with identical lifetime incomes will *often* bear substantially different tax burdens depending on how that income is divided among the several taxable years."[104] Their supporting quotation from Vickrey's 1939 article makes no mention of the empirical frequency of the phenomenon, only describing it as a logical possibility arising under an annual system with graduated rates.[105] Probably the best interpretation of the phrase "will often bear" in that context, therefore, is "could conceivably bear."

In any case, Batchelder provides evidence regarding the frequency and significance of income volatility. As discussed below, she finds that the phenomenon is not widespread (although it has increased recently) and that income volatility's impact on tax outcomes hits low-income taxpayers much harder than those in other income classes.[106] The normative concern with the poor that I emphasize in this article, therefore, aligns with the empirical reality of who is being most harmed by paying taxes on annual incomes.

2. The Moral Significance of the Horizontal Equity Problem

The question of equity, then, comes back to the question of who is "like" whom. If people earning $180,000 in a year think of themselves as being in that income class, and if others think of them as being in that income class, then it will seem inequitable to treat them like a $100,000 annual earner. Indeed, doing so would itself be perceived as inequitable, because in a given year different people who earn $180,000 would pay different tax bills. "Thus, movement toward horizontal equity between two taxpayers of equal lifetime incomes makes the system less horizontally equitable for pairs of taxpayers with the same annual incomes."[107]

In other words, the question of who is alike for tax purposes has no right answer. From an annual perspective, taxing average income leads to horizontal inequity, while from a multi-year perspective,

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103 Schmalbeck, *supra* note 34, at 547–48.

104 Fennell & Stark, *supra* note 67, at 24 (emphasis added).

105 *Id.* at 24 n.95 (quoting Vickrey, *Averaging of Income 1939*, *supra* note 12, at 379).

106 Batchelder, *supra* note 5, at 411–19. See especially *id.* at 415.

107 Schmalbeck, *supra* note 34, at 547.

taxing annual income leads to horizontal inequity for the same reasons. To take a more extreme example, is a person who earns $64,000 per year for forty years "like" someone who earns $40,000 for thirty-nine of those forty years and $1,000,000 for one year sometime during that time period, such that they should both pay the same (interest-adjusted) amount in taxes? Certainly a case can be made that the person who received a million dollars in one year is unlike the other person in very important ways; but the point is merely that it is not presumptively the case that average incomes are superior to annual incomes in judging horizontal equity.

The moral case for addressing purported horizontal equity by adopting income averaging, therefore, does not upon examination appear to be presumptively strong. Two people who earn similar amounts over many years but who pay different tax rates might well differ in important ways that make the significance of their different average tax payments seem less arbitrary (and many might be able to mitigate those effects through self-help, as discussed in Part IV.D.1 below). Therefore, even if we know that two people who earn similar amounts over the space of several years pay different amounts in taxes, we have to ask whether the gain from addressing that concern is morally significant. As a general horizontal matter, I do not think that it is.

Does this mean that we should completely ignore horizontal equity as a policy concern? To take an extreme case, would it make no difference at all if Bill Gates and Warren Buffett (to the extent that these fabulously wealthy men receive similar levels of income over time and are otherwise alike in ways that are broadly accepted as meaningful) paid significantly different tax bills? One answer is that failing to tax one of these men at the higher rate implies a loss of revenue, which means that we are missing out on an opportunity to have a revenue-neutral tax change that could help middle and lower-income earners. Other than that, though, the moral outrage generated by vertical inequities that I describe in Part IV.C below is simply missing from the analysis of horizontal inequities.

3. The Costs and Benefits of Adopting an Averaging Plan

Of course, even a mild moral case for treating likes alike will be compelling if there is no cost to addressing a horizontal inequity. The point here is not that we would have no reason at all to address horizontal inequities in the abstract but instead that any costs associated with addressing this kind of horizontal inequity (if, again, it is even viewed as treating likes not alike) are likely to tip the scales against the change.

What might those costs include? The most obvious are the political difficulties associated with getting any tax change enacted. Senator Charles Grassley, the current chair of the Senate Finance Committee, once noted the difficulties raised by the requirement to find offsetting changes to revenue losses created by Treasury regulations:

> I have had the experience myself of having to get corrective legislation through.... [T]hose of us who want to [pass corrective legislation are faced with] not only getting the bill written, finding all of the cosponsors that one needs, but also, then, when you actually get to the point of offering the amendment, you have to come up with an offset.[108]

While Grassley's concerns were in part motivated by a legally-imposed requirement of literal revenue neutrality, he also makes clear that it is hardly a simple process to pass tax legislation. It is, of course, possible to imagine adding an averaging provision (or any other tax change) onto a bill that is otherwise going to pass, but to imagine such a possibility is merely to concede that any particular piece of legislation is generally rather difficult to pass. Other than the happenstance of finding an existing legislative vehicle on which to take a free ride, getting the tax law changed is difficult. (Of course, even getting a provision added to a bill is never guaranteed.) While a general description of the political process in changing the tax code is well beyond the scope of this article, it is at least worth emphasizing that nothing happens without a cost.

In addition to the legislative costs of adopting legislation to allow for averaging of income, there are transition costs associated with any change. Because we are not writing on a blank slate, there is always a social cost associated with educating the public about a change and getting them to work with the new system.[109] At the most basic level, there is what might be called an "efficiency of the familiar," which is simply to say that it is cheaper to allow people to continue to do what they are doing rather than forcing them to adapt to something new.

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[108] 144 CONG. REC. S4413 (daily ed. May 6, 1998) (remarks of Sen. Grassley, R-Iowa).

[109] For a book-length discussion of transition costs in taxation, see DANIEL N. SHAVIRO, WHEN RULES CHANGE: AN ECONOMIC AND POLITICAL ANALYSIS OF TRANSITION RELIEF AND RETROACTIVITY (2000).

There is also an administrative cost associated with any attempt to treat differences in taxpayers more finely than we currently do. As an analogy, consider the current tax treatment of capital gains from the sale of a home. Under the current law, taxpayers can escape taxation on such gain if "during the 5-year period ending on the date of the sale or exchange, such property has been owned and used by the taxpayer as the taxpayer's principal residence for periods aggregating two years or more."[110] This exclusion is limited to $500,000 for most joint tax returns and $250,000 for single taxpayers.[111]

One obvious effect of these provisions is that they prevent those who buy homes and sell them for a quick profit from taking advantage of a tax benefit that is clearly intended to assist middle-class homeowners. Even so, Congress recognized that there will be situations in which homeowners who are not motivated by profit might find themselves selling houses that they have lived in for less than two years. If so, they are now permitted to exclude a fraction of the maximum exclusion, based on the amount of time that they actually did own the home (e.g., a single person living in a house for one year can exclude up to $125,000 in gain).[112] That partial bailout is limited, though, to sales due to changes in "place of employment, health, or . . . unforeseen circumstances."[113] Even with this level of detail (with regulations necessary to clarify such issues as what constitutes "unforeseen circumstances"), it is still possible that a person might sell succeeding principal residences twice in less than two years, not because she is changing jobs or due to health issues yet also not because she is buying and selling homes for profit (and is thus not the presumed target of the tax writers). Someone who lives in a house for two years receives much better tax treatment than a similarly situated person who lives in their house for only one year and 364 days. Fine-tuning the tax code still further to relieve such horizontal inequity is possible, but at some point we decide that taxpayers will have to live with the consequences of their decisions (even if they made their decisions in ignorance of the details of the tax law). The cost simply is not worth the benefit.

The analogy between income averaging and home sales is hardly perfect, of course, but it at least illustrates that our decision whether or not to fix this "inequity" depends in part on how common we think

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[110] I.R.C. § 121(a).

[111] I.R.C. § 121(b).

[112] I.R.C. § 121(c).

[113] I.R.C. § 121(c)(2)(B).

it is and how costly we expect it to be to alter the tax code — and to do so with well-crafted legislation that is implemented appropriately.

In this article, I make no claim that the costs of adopting income averaging provisions into the tax code are "large" or "small" in any systematic sense of those words. Indeed, if they could be measured accurately, the costs might well turn out to be nominal. If I am correct that there is a very weak moral case for fixing the possible horizontal inequities that worried Vickrey, though, then even trivial costs might be enough to cause us not to adopt an averaging proposal on horizontal equity grounds. As I will argue below, the case for making income averaging available to some groups of taxpayers gains traction not on horizontal equity grounds but on vertical ones. Making income averaging available to some taxpayers is worth the cost if the beneficiaries, to put it simply, "need help."

C. *Progressivity as a Goal of Tax Policy*

This section looks directly at the question of progressivity in the tax code — why it is good and how to achieve it, leaving aside the economic or administrative effects of tax reform.[114] For all of the discussion of changing our tax system to some less progressive alternative,[115] the basic and continuing commitment to progressivity has been notable in the U.S. federal tax system.[116] Given the widespread acceptance of progressivity as a feature of income tax systems, it might be tempting simply to take progressivity as a given in

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[114] Although it may go without saying, it cannot hurt to note that the term "progressivity" is somewhat misleading in the context of tax policy, because of the increasing use of the word "progressive" as a synonym for left-leaning or liberal political thought. While many (if not most) people who identify themselves as politically progressive also support a progressive tax system, not all do; nor do all non-progressives reject tax progressivity. *See* Mark S. Hoose, *The Conservative Case for Progressive Taxation*, 40 NEW ENG. L. REV. 69, 110 (2005) ("[A] case can be made out for classical conservative support of the current system of progressive income taxation."). Similarly, even those who support progressivity need not support a progressive tax on an income base. *See* Edward J. McCaffery & Richard E. Wagner, *A Bipartisan Declaration of Independence from Death Taxation*, 88 TAX NOTES 801 (Aug. 7, 2000), where McCaffery identifies himself as a liberal who supports a highly progressive consumption tax.

[115] *See generally* McNulty, *supra* note 3.

[116] *See* Stein, *supra* note 18. Stein argued that "[N]one of the tax reform proposals now in circulation would reject progressivity." *Id.* Ten years later, that remains true — because the tax reform proposals in 2006 are basically the same proposals that were being discussed in 1996.

the analysis below.[117]

The argument here, though, is not merely another general call for progressivity. I argue more specifically that the normative values that underlie popular and scholarly support for progressivity are most potent when we are concerned with the poorest among us. That is, arguments in favor of progressivity are fundamentally based on arguments to help lower-income earners; and while those arguments continue to have force when thinking about the appropriate taxation of a person who earns, say, $600,000 versus someone who earns $6,000,000, the arguments are much less powerful than when comparing either of those earners to someone earning $16,000. Progressivity matters most at the lower end of the spectrum. As we look at higher income levels, progressivity matters relatively less and other issues such as administrability and simplicity matter relatively more.

As noted, progressivity was also a core focus of Vickrey's analysis:

> [T]he personal income tax [should not be] forced to yield place to arbitrary or regressive forms of taxation.... [C]umulative averaging may well be the essential key to retaining for the personal income tax its proper role in an adequately progressive revenue system. More than ever, it merits first place in any 'Agenda for Progressive Taxation.'[118]

Why should the government attempt to redistribute money from the successful to those who are less so? There are, of course, a number of moral and philosophical traditions that attempt to answer that very question, and the literature on this issue is vast. A very good addition to that literature, which also reviews the literature on tax justice in a comprehensive and comprehensible manner, is the recent book by Murphy and Nagel.[119] As they argue, issues such as tax incidence are of only instrumental importance, with the real goal being to know "whether a given change in the tax law will increase or reduce inequality, the level of welfare of the worst off, equality of

[117] *But see* Robert L. Bartley, *Jack Kemp vs. Henry Simons*, WALL ST. J., Jan. 18, 1996, at A14 (lamenting Henry Simons' role as the "godfather of the notion that the tax system should be used to redistribute income," and advocating the argument that "if one taxpayer earns ten times as much as his neighbor, he should pay ten times as much in taxes" – though even that proposal maintains at least nominal progressivity by allowing for a personal exemption).

[118] Vickrey, *After Thirty Years 1972*, *supra* note 12, at 132–33.

[119] MURPHY & NAGEL, *supra* note 95.

opportunity, and so on."[120] In other words, common tools of tax analysis such as distribution tables are helpful, but the real issue is the justice of the after-tax outcomes, not whether a tax system has steep or flat progression or any other systemic feature.[121]

Murphy and Nagel's concern with inequality is well placed, as long-term trends towards ever-greater inequality in the United States continue to intensify:

> [N]ew CBO data . . . show that the income gap widened significantly between 2002 and 2003. The income gap had narrowed somewhat in 2001 and 2002, due in part to the sharp decline in the stock market after its peak in 2000. The data for 2003, however, show a return to the long-term trend of increasing income inequality. Further, other available evidence from the Census Bureau and from surveys of executive pay indicate that income inequality has continued to grow in the years since 2003.[122]

The introduction of vertical equity into the discussion, therefore, supports the argument in Part IV.D below that Vickrey's concerns for horizontal equity will have their greatest resonance inasmuch as they address problems related to the poor. I will argue that horizontal concerns among higher-income workers raised by the annual tax accounting system are a matter of much lesser concern than those raised by middle and, especially, lower-income earners. Vertical concerns, therefore, ultimately should drive the decision on whether to use income averaging, and if so, to whom it should be available.

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[120] *Id.* at 131.

[121] *Compare* Tom Daley, *Progressive? Yes. But Steeply Progressive?*, 109 TAX NOTES 395 (Oct. 17, 2005) ("[T]he U.S. system is progressive. How progressive is open to debate, because measures like taxes paid as a percentage of AGI reported are blunt instruments, at best, for assessing the fairness of a tax system.") *with* Jim Saxton, *JEC Chair Saxton Responds to Tom Daley*, 109 TAX NOTES 685, 685–86 (Oct. 31, 2005) ("Given . . . that the top percentiles of tax filers pay taxes well in excess of their share of AGI, it is not misleading to describe the federal income tax as steeply progressive.").

[122] Isaac Shapiro & Joel Friedman, *New CBO Data Indicate Growth in Long-Term Income Inequality Continues* (Ctr. on Budget & Policy Priorities, Washington, D.C.), Jan. 30, 2006, at 1, *available at* http://www.cbpp.org/1-29-06tax.pdf.

1. The Basics of Progressivity

In a strict definitional sense, tax progressivity is a question of simple arithmetic: a tax system is progressive if the fraction of income paid in taxes rises as income rises. Of course, it is possible for this fraction to rise and fall in different ranges of the income distribution, so that an entire tax system might exhibit progressivity, regressivity, and proportionality in different segments of the income range.

In evaluating a *change* in the tax system, a policy is progressive if it increases the difference in the fraction of income paid in taxes as income rises, with regressivity and proportionality defined analogously. In other words, it is possible to propose a system that, in the strict sense, is progressive; but the change from the old system to the new one can still be a regressive change if the difference in the proportion of taxes paid by rich and poor is smaller than under the old system. For example, moving from a system with a range of average tax rates between 0% and 50% to system where the range (over the same income levels) is 15% to 16.9% is a regressive change from a more progressive system to a less progressive system.

It is extremely important to note that advocacy of progressive taxation does *not* require one to believe that the highest income people did not "earn" their high returns.[123] That is, it is possible to believe that the richest taxpayers should pay a larger share even while believing that they otherwise "deserve" what they have been paid (in the sense that their earnings are not distorted by any market imperfections). This simply means that the highest-income earners will still be asked to pay a higher percentage of their income than the lowest — leaving everyone in the same relative positions that they started from, but closer together in absolute terms.[124] Since this is a

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[123] *Cf., e.g.*, *Tyco's Former Top Lawyer Says He Deserved Big Bonus*, N.Y. TIMES, June 25, 2004, at C3 ("Tyco International's former general counsel . . . told jurors yesterday that he earned 'every dollar' he got from the company, denying a government charge that he stole a $17 million bonus.").

[124] On the other hand, for those who believe that the reward structure of the economy is well-calibrated to the amount of a person's talents and efforts, it is possible to argue that high-income earners are "better" members of society than are others who earn less. That is, if a person starts a business, and that business is successful, they have not only bettered their own lives but those of many others. From there, it could be argued that the tax system should be regressive, if not actually exempting high-income people from all taxes outright. The way for society to pay tribute to these people for their extraordinary contributions, this line of reasoning might continue, is to forgive any tax obligations that their incomes might create. What would remain unclear from such a line of reasoning is why it is only an

moral judgment, it could even coexist with the concern that progressive taxation might somehow "punish" the most able in society, since the punishment can be judged to be more or less acceptable depending on one's moral views of how badly off we can allow the least able members of society to be.

For those who believe that the market system does not always allocate rewards in perfect proportion to a meaningful notion of just desserts, however, the case for progressivity is even easier to make. If one believes that the wages and salaries determined by the market system are not determined by each worker's marginal productivity, for example, it becomes relatively simple to argue that progressivity is an appropriate goal of tax policy. Quite simply, if rewards do not flow systematically from productivity, it would become the duty of those who *oppose* progressivity to justify the high incomes of the winners, rather than the other way around. If there is a random element to income determination — luck, if you will — then there is nothing morally suspect about taxing people's income at progressive rates.[125]

2. Utility and Progressivity

The argument for a redistributive, progressive tax system is often expressed in a familiar, technical form. Early economists made "the basic case for progressivity" by saying that, "because the utility of another dollar of income is smaller the larger a person's income is, taking a dollar from a rich person imposed less sacrifice than taking a dollar from a poor one."[126] This argument has a great deal of normative appeal, tapping into the notion that $50,000 spent on the birthday party of a rich person's one-year-old could not possibly generate as much happiness as $5 spent on meals for 10,000 poor people. Or, to put it more colorfully: "Paris Hilton very likely has a much lower marginal utility of money than someone slaving in the salt mines 60 hours a week to support his family. Redistribution from Paris Hilton to the worker makes sense."[127]

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argument for zero taxes on the rich, rather than outright reverse-Robin Hood strategies, i.e., income-based subsidies to those with incomes above a certain level. This argument is clearly not one that I advocate. It simply reminds us that the notion of "just desserts" can lead us in sometimes surprising directions.

[125] *See* Hal R. Varian, *In the Debate Over Tax Policy, the Power of Luck Shouldn't Be Overlooked*, N.Y. TIMES, May 3, 2001, at C2.

[126] Stein, *supra* note 18.

[127] Joseph Bankman & David A. Weisbach, *The Superiority of an Ideal Income Tax Over an Ideal Consumption Tax* 11 (Colloquium on Tax Policy & Pub. Fin., N.Y. Univ. Sch. of Law, Working Paper No. 8, 2006), *available at* http://www.law.nyu.edu/

As is now well known, though, the elusive nature of utility makes this argument largely a matter of conjecture. First, it is possible that individuals or groups simply might not experience declines in utility when receiving more income. It violates none of the axioms of economic rationality for a person to be equally happy with each new dollar received as they were with the last. A person might even become increasingly money-grubbing as they earn more money, thus finding herself happier and happier with each new infusion of cash. This, though, seems unlikely to be a general phenomenon (and might even qualify as a psychological disorder), and "an assumption of declining marginal utility of wealth seems an unproblematic assumption."[128] But again, we do not really know how widespread this phenomenon might be.

Second, even if individuals experience diminishing marginal utility, comparisons between individuals might not support the standard argument for redistribution. If a wealthy person receives generally higher utility from money than a poor person does (though both experience declining marginal utility as income is received), it might well be the case that the increase in the poor person's utility is not large enough to offset the decrease in the wealthy person's utility.

For some, the conclusion is obvious: "[O]nce we realized that there was no way to compare or add together the utilities of different people, the idea of minimizing some national total of sacrifice flew out the window."[129] One can then put the argument for progressive redistribution as simply as saying that extreme inequality is "unjust or unlovely" and that a progressive income tax is a good way to reduce inequality.[130] This does not, of course, purport to be an argument but simply expresses moral revulsion at inequality in an especially memorable way.

Rather than simply rejecting the notion of comparing different people's utility, though, one can accept that this is a matter of conjecture but still use the concept of diminishing marginal utility of money as a helpful heuristic to describe the "unloveliness" of inequality in a more mechanical manner. "[I]t may not be inappropriate for society to conclude that a taxpayer's high personal utility from uses of certain resources – such as a second Rolls Royce

colloquia/taxpolicy/papers/06/Bankman-Weisbach.doc.

[128] *Id.* at 10 n.13.

[129] Stein, *supra* note 18.

[130] *Id.* (describing the views of Henry Simons).

— has less social worth than alternative uses."[131] We draw this conclusion not because we really believe that all people have the same utility functions, but because "they may be appropriately treated as though they did."[132]

Having made this assumption, the next step is simply to say that it is highly probable that the utility gain from helping a truly destitute person is presumptively quite high — and certainly higher than utility losses due to taking money away from higher-income earners. Even if we are comfortable with that analysis, though, it is less clear that such a comparative utility analysis works well among higher-income earners. Moving from $10,000 to $11,000 in disposable income is almost certainly much better than going from $100,000 to $101,000, or from $1,000,000 to $1,001,000. As income rises, though, the comparisons become harder to justify. While it feels comfortable assuming that a person who makes $20,000 is much, much better off than one who makes $10,000 (and that their extra happiness from the increased income of $10,000 is much, much larger than the lost happiness of someone whose after-tax income drops from $750,000 to $740,000), it is less certain that someone who makes $740,000 is better off in utility terms at all than someone who makes $700,000 — or, more importantly, that taking $10,000 from the $740,000 earner would generate less unhappiness than taking it from the $700,000 earner. At the very least, it is fair to question that assumption.

In short, utility analysis can be used not only to justify progressivity in general but to support the basic approach adopted here, that the notion of progressivity matters most at the low end of the income spectrum. Designing a tax system from scratch, one would of course adopt progressive rates throughout the income scale; but if we were only looking at differences among those whose basic needs are already being comfortably satisfied, the case for progressivity would be much less compelling. The normative case for progressivity is, in other words, mostly about the least fortunate among us.

3. Rawls and Distributive Justice

The flexibility of utilitarian computations discussed in the preceding section is an important element of the philosophical literature on distributive justice. The "pure priority view" of distributive justice "counts an improvement to the welfare of someone

[131] Schmalbeck, *supra* note 34, at 550.

[132] *Id.*

worse off more heavily than an improvement of the same absolute magnitude to the welfare of someone better off."[133] This approach simply allows one to adopt some kind of utilitarian calculus that has been modified to count gains to the poor as explicitly more important than numerically comparable losses to the rich.

The extreme version of this argument treats improvements to the conditions of the worst off as having strict priority over any losses to the better off. This is embodied in Rawls's difference principle, "according to which differences in wealth and standard of living between different social groups are justified only to the extent that the system that generates those inequalities also does at least as well for the interests of the worst-off group as any alternative system."[134]

The importance of Rawls's difference principle is that it prevents even a society with a small number of poor people from deciding that the losses to the nonpoor from redistribution are (even though those losses are discounted by some amount because they are not borne by the poor) large enough that it is acceptable to tolerate a permanent underclass.

Volumes have been written on these and other philosophical issues in taxation. The point once again is that, like the arguments from pure utilitarianism and from the Judeo-Christian perspective (discussed below), there are respectable (and even convincing) philosophical theories of distributive justice that call not just for progressivity in taxation but for progressive tax polices that are motivated by — and aimed toward alleviating — the problems associated with the least well off in society. The further we move away from the lowest-income taxpayers, the less moral strength there is in arguments to alleviate horizontal or vertical inequities.

4. Judeo-Christian Morality

As noted above, there is a surprisingly broad consensus that progressivity should be a central concern of tax policy. Where does this consensus come from? While the utility-based and related philosophical analyses discussed above provide support for progressivity, the basis for this broad support in the United States quite likely flows more directly from the Judeo-Christian emphasis on compassion for the poor. This compassion for the poor goes hand in

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[133] MURPHY & NAGEL, *supra* note 95, at 53 (citing DEREK PARFIT, EQUALITY OF PRIORITY? THE LINDLEY LECTURE (1991)).

[134] *Id.* at 54 (citing JOHN RAWLS, A THEORY OF JUSTICE, ch. 2 (revised ed. 1999)).

hand with a concern for some in society being "too rich,"[135] although the two concerns are not necessarily connected. Such terms as "grotesque" and "obscene" are commonly used to describe large amounts of wealth — as well as overt displays thereof.[136] These terms might be invoked when arguing, for example, that it is simply unacceptable to have poor mothers choosing between feeding their children or buying them medicine while others in the society choose between Porsches and Mercedes.

Susan Pace Hamill recently published a law review article discussing scriptural bases for tax progressivity, focusing on tax inequities in her home state of Alabama.[137] Looking at both the Old and New Testaments, Hamill argues: "From these biblical texts two broad moral principles of Judeo-Christian ethics emerge, . . . forbidding the economic oppression of low-income [persons] and requir[ing], not only that their basic needs be met, but also that they enjoy at least a minimum opportunity to improve their economic circumstances and, consequently, their lives."[138] Hamill points out that the ability-to-pay principle is supported by her scriptural sources: "[W]hen distinguishing ethical from unethical tax structures, Judeo-Christian ethics use broad principles similar to traditional tax policy theory, both indicating that tax burdens should be apportioned according to some measure of the taxpayer's ability to pay . . . ."[139]

Most importantly, the poor occupy a central place in Hamill's summary of Judeo-Christian ethics. More than anything else, she says, the poor must occupy our attention in designing tax policies: "At a minimum, the income tax structure must be reformed to raise the exemptions to a sufficient level so that individuals and families below

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[135] Clearly, however, this conflicts with other tenets of the American psyche, that "more is better" and that winners are better than losers. If one recognizes that high tax rates do not actually make rich people poor, however, perhaps this is not a contradiction at all.

[136] *See, e.g.*, Gretchen Morgenson, *A 'Holy Cow' Moment in Payland*, N.Y. TIMES, Feb. 19, 2006, § 3, at 1 ("Everybody knows that executive compensation at many companies has been obscene. What everybody does not know is how obscene obscene is now.").

[137] Susan Pace Hamill, *An Argument for Tax Reform Based on Judeo-Christian Ethics*, 54 ALA. L. REV. 1 (2002). Professor Hamill continues her discussion of these issues in a more recent article. Susan Pace Hamill, *An Evaluation of Federal Tax Policy Based On Judeo-Christian Ethics*, 25 VA. TAX REV. 671 (2006); *see also* Adam Chodorow, *Tax Reform: What Would God Do?*, 108 TAX NOTES 1167 (Sept. 5, 2005).

[138] Susan Pace Hamill, *An Argument for Tax Reform Based on Judeo-Christian Ethics*, 54 ALA. L. REV. 1, 8 (2002).

[139] *Id.* at 4.

the poverty line do not pay any income taxes."[140]

While scripture provides strong support for the idea that morality requires concern for the poor, at the same time there is very little evident concern about the relative treatment of those who are doing well. In relation to the horizontal equity concerns addressed by income averaging, it is difficult to find guidance in scripture about how to treat two people who earn, say, $200,000 over two years, where one earns $80,000 and $120,000 while the other earns $100,000 and $100,000. This is not to say that scripture supports horizontal *inequity*, of course, but only that the vertical equity question is the exclusive focus of the moral analysis.

The lesson to be learned from Hamill's scriptural analysis, therefore, is that the focus of tax policy should be directly on helping the poor. There is no conflict between the utility-based arguments above and the religion-based argument here.

D. Does Cumulative Averaging Appropriately Address Fundamentally Important Policy Concerns?

As discussed earlier, the fundamental threshold issue addressed in this article is whether the gains from adopting any system of income averaging would be worth the cost of enacting and administering the system. This question would remain even if there were only minor costs and tradeoffs involved in adopting any given proposal, because even a little bit of pain can be sufficient to outweigh very minor gains.

It is useful to evaluate the importance of the problem that cumulative averaging would address in the context of the arguments for horizontal and vertical equity discussed above.[141] As described earlier, the policy conclusion is that the gains from adopting income averaging do not generate compelling arguments for allowing averaging except among lower-income earners.

1. Averaging and High-Income Earners

Schmalbeck's 1984 paper was most directly focused on the then-current system of income averaging, as discussed above.[142] His analysis "suggest[ed] that outright repeal of the income averaging provisions would save considerable tax revenue, improve the vertical equity of the tax system, and put the horizontal equity of the tax

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[140] *Id.* at 77.

[141] *See supra* Part IV.B–C.

[142] Schmalbeck, *supra* note 34, at 512–23, 557–64.

system on a sounder footing by consistently using an annual rather than a multiyear standard of measurement."[143] Not knowing that the averaging system would soon be completely repealed (indeed, viewing immediate and complete repeal as a "somewhat radical suggestion"),[144] Schmalbeck offered a menu of choices to improve the averaging system without completely repealing it.[145]

With the system that was the object of Schmalbeck's ire now history, his paper still provides an excellent critique of the equitable arguments in favor of any averaging system. Using that paper as a touchstone, I discuss here the basic question that Vickrey seems to have taken for granted: Should we really care about the effects of income fluctuations on tax liabilities, especially among those who might occasionally rise into the highest earning ranks? Schmalbeck's arguments that the answer is generally "no" remain persuasive today, and there is a basic equity argument to investigate before returning to his important work.

As described above, the most basic case for averaging of income proceeds from the undeniable observation that an annual accounting framework is arbitrary and that income volatility is likely to have arbitrary effects in a system with graduated marginal tax rates. Such a result seems to violate the notion of horizontal equity, by which "the system should not burden some individuals significantly more than others on the basis of trivial differences in economic status."[146] The horizontal inequity that would be addressed by income averaging, though, is upon closer inspection not a matter of great concern from the standpoint of addressing social inequality.

One source of annual income volatility is, of course, the type of employment in which a taxpayer is engaged. Many (almost certainly most) types of jobs provide regular paychecks on a weekly, bi-weekly, or monthly basis. Even when there are intense periods of the year and slow periods of the year (for example, when law professors grade exams versus almost any other time of year[147]), employers typically still spread pay out evenly. Even so, not everyone receives income on

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[143] *Id.* at 564.

[144] *Id.*

[145] *Id.* at 564–76 (suggesting changes in the statutory formula for computing average income, an option to average when income declines precipitously, and election of a self-averaging device to spread out the taxes due on large, nonrecurrent receipts of income).

[146] *Id.* at 546.

[147] As one uncredited wag said about teaching in law school (and doubtless elsewhere in academia): "They pay us to grade. We teach for free."

a regular basis.

It is somewhat surprising, though, that examples of taxpayers whose incomes are likely to be highly volatile on an extended basis are not easy to come by. In colloquia and classroom presentations, the example that I found myself invoking regularly was professional athletes, who have high incomes — sometimes stunningly high incomes — during their very short careers and (except in a tiny number of cases where endorsement deals are available or the young retiree works in broadcasting) have very low earned income thereafter. Entertainers seem to fit the category, too, with the prototype being someone lucky enough to be cast on a successful television program for a few years before sliding into has-been obscurity.

These are perhaps interesting (though small) categories of earners, and I discuss the merits of their situations below; but are there other — perhaps more obviously compelling — examples of taxpayers who pay unjustly high taxes because of our annual system of taxation? Given that a revenue-neutral system could impose higher taxes on everyone else in order to erase this supposed inequity, the answer to this question has direct consequences for everyone.

If one of the consequences of choosing the highly uncertain (but apparently quite fulfilling) life of an adored athlete or a pampered actor is that you pay higher taxes because of your volatile income, the difference can easily be dismissed by those who care about progressivity as being not a matter of great moral outrage. The higher taxes are not horizontally inequitable, because these categories of employment are meaningfully different from all others. The slightly lower after-tax lifetime income might even be viewed as the price one pays for actually being able to live one's dream — a dream shared by many but achieved by very few.[148] Viewed in horizontal equity terms, therefore, the system does not fail to treat likes alike, because there

[148] Another dream shared by many is winning the lottery. Certainly a lottery win could push a person's income into a higher tax bracket. What Schmalbeck noted in 1984 appears to be just as true today, however: lotteries at least offer the option for recipients to receive their winnings in annual installments, sometimes over the space of decades. Schmalbeck, *supra* note 34, at 556 n.167. If that option exists (and especially if it is mandatory), then there is no horizontal equity issue for someone who wins $1 million in the lottery compared to someone who has the same average income over their lifetime. The lottery winner can pay less tax on their $1 million, if they care to, by reducing their annual payments in a structured pay-out. If the gross amount of the lottery jackpot is so large that such a strategy still results in twenty or twenty-five years of being taxed at the maximum rate, then there is little that a lifetime averaging scheme could do to reduce the lucky winner's aggregate tax liability.

are nonpecuniary differences that can justify treating these volatile earners differently.

Are there other, less easily dismissed, examples? Notably, Vickrey offers only "athletes, authors, and others enjoying a brief bonanza, who would be able to claim a rebate or refund if their income subsequently fell back to a low level."[149] Schmalbeck critically discusses the classic hypothetical example of a novelist who struggles while writing her first book, waiting tables or driving a taxicab and living in "an artsy but essentially deplorable neighborhood."[150] He demonstrates, in fact, that neither Vickrey nor I are unique in focusing on the actor/athlete/author category for our examples. "Novelists with this approximate career pattern provide a major archetype for advocates of income averaging."[151] Schmalbeck points out that the novelist archetype is cited in congressional committee reports,[152] congressional testimony,[153] and articles.[154]

Those who make a living writing the occasional book (a book that must, by assumption, be a large enough seller to cover expenses for the years of near-zero income, making them very rare even among would-be career authors) do not seem — even in conjunction with athletes and actors — to offer sufficient reason to adopt a system of income averaging. I am not aware of any polling data on the subject, but if most people would view these successful professionals as among society's luckiest people, it becomes difficult to see where the political will for this kind of tax reform would lie.[155]

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149 Vickrey, Level Playing Field 1995, *supra* note 12, at 5.

150 Schmalbeck, *supra* note 34, at 553.

151 *Id.*

152 *Id.* at 553 n.160 (citing as an example H.R. REP. NO. 88-749, at A174, *reprinted in* 1964 U.S.C.C.A.N. 1313, 1599).

153 *Id.* at 553–54 n.161 (citing, as an example, *Tax Reform: Hearings before the H. Comm. on Ways and Means*, 91st Cong. 1935 (1969) (statement of Michael Waris, Jr.)).

154 *Id.* at 554 n.162 (citing, as examples, M. Carr Ferguson & Edwin T. Hood, *Income Averaging*, 24 TAX L. REV. 53, 91 (1968); Leslie C. Smith, *How to Become Miss America Without Achieving Any "Major Accomplishment" — Some Thoughts on Income Averaging Provisions of the Internal Revenue Code*, 54 MARQ. L. REV. 329, 344 (1971)).

155 Schmalbeck also mentions inventors, lawyers on large contingent fee cases, and entrepreneurs. *See id.* at 554. Perhaps such groups could generate more public sympathy for their situations, though it is not clear why people who achieve great financial success in these fields would be any more sympathetic than actors, athletes, or novelists.

Beyond political will, though, this analysis brings us back to the moral question of why we might change our system of taxes at all. As argued throughout this article, tax analysis appropriately includes normative questions of personal and social fairness. Would a policy analyst whose concerns for progressivity arise from a Judeo-Christian perspective, for example, be particularly concerned with this type of injustice?[156] Would Hamill's focus on the plight of the poor be shifted to the plight of those whose incomes are temporarily high because they won a lottery or landed a role on a television show?[157] Given that her concern is for the least among us, it is difficult to picture her being unduly troubled by the purported horizontal inequity that we see here.[158]

Notwithstanding these philosophical arguments regarding progressivity, it turns out that the case for providing relief to the suddenly successful author, athlete, or artist is weak on other grounds as well. Schmalbeck does not dwell on the generally unsympathetic position that the archetypal candidate for averaging might occupy, along the lines discussed above. Instead, he points out that the system is already treating such a person fairly well. To begin, given that there is a zero bracket for those with sufficiently low incomes, the future successful author is likely to pay zero, or at least very low, taxes while they live the life of the starving artist.

When success arrives, the income that so eluded her finally flows into the novelist's bank account.[159] She lives the good life, with the opportunity to take trips and to live in conditions that are far from deplorable. She pays more taxes (or maybe even begins to pay federal income taxes for the first time) and at a higher marginal rate. Why does society owe her a break on taxes? Surely not on an ability-to-pay principle, because we have hypothesized that she possesses the ability

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[156] *See supra* Part IV.C.4.

[157] Hamill, *supra* note 138.

[158] The most sympathetic group, perhaps, is the disappointed athletes who diverted all of their attention in their youth to honing their athletic skills, only to learn that they are not quite good enough — or worse, only to suffer a debilitating injury without ever having earned a large salary — and spend the rest of their lives on a lower earning pattern than if they had focused on developing another career. Clearly, those who fall into this group are not candidates for income averaging.

[159] Of course, if success remains a stranger, we are simply looking at — from the standpoint of the tax system, at least — a permanently low-income worker. Unless the frustrated author's meager income is itself derived from a volatile source (which is surely not the case for the classic example of the person who waits table or drives a taxicab), income averaging is simply irrelevant. If it is relevant, the very limited system described and endorsed below could deal with the situation.

to pay taxes in her good years at higher average and marginal rates.

Moreover, as Schmalbeck notes, successful authors are in a position to control their financial affairs to a substantial degree, engaging in "self-averaging" to mitigate the effects of an annual tax system.[160] Now a draw on the lecture circuit, our novelist can decide (within limits) when to lecture, when to write her next book, when to be paid for it, and whether to take an advance. And she is not alone, given that "a sizable industry exists for no other purpose than to provide . . . advice [to] structure her professional life to accomplish a good deal of income shifting or deferral by means of Keogh plans, royalty assignments to trusts, Individual Retirement Accounts, and the like."[161] Even if these devices did not exist, it would still be difficult to make a strong equity-based argument that our author deserves a tax break. Simply saving her money and engaging in basic financial planning should provide her with a very comfortable future - certainly a more comfortable future than the one that faces those who will never become famous authors.

Still, there might be something to the argument that, even if a successful author is not a particularly sympathetic subject in the scheme of society as a whole, horizontal inequity exists as between, say, a newly-successful novelist and a novelist who has been successful for a long time. If they both write books in a given year that bring them two million dollars in royalties, why should the more comfortable senior author pay the same tax as the younger author who is only enjoying the first fruits of success?

While intriguing, this argument confuses income and wealth. The senior author's presumed greater comfort would derive from previous income, which has already been taxed at relatively high rates, and from current taxable income derived from accumulated wealth (which is also presumably being taxed at high rates). Given this important difference, Schmalbeck argues that "comparisons based on wealth are somewhat inappropriate when one is evaluating an income tax."[162] The two authors are not, in other words, similarly situated, making the appearance of horizontal inequity an illusion.

In sum, income averaging — especially when aimed at reducing the tax inequalities faced by high-income taxpayers — lacks a strong

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[160] Schmalbeck, *supra* note 34, at 554.

[161] *Id.* at 553. Obviously, the menu of tax management devices changes over the decades, but the tax advising field is going strong. For an updated list of available averaging devices, see Edward A. Morse, *Income Averaging: Planning Options for Eligible Taxpayers*, 22 J. TAX'N INVESTMENTS 303 (2005).

[162] Schmalbeck, *supra* note 34, at 555.

equity-based argument that resonates with the notion of progressivity that motivates this article (and, indeed, that seems to motivate so much of Vickrey's work). Yes, there might be somewhat more compelling examples of horizontal inequities generated by an annual system of taxation, and some taxpayers will be less able than others to mitigate those inequities. It is interesting, though, that even after more than half a century of advocating his system of income averaging, Vickrey did not offer any examples beyond the actors, authors, and athletes discussed above.

The more prevalent such inequities are, the more likely it is that people will care enough to try to change the system. As I discuss below, the empirical evidence on the prevalence of income volatility suggests that the problem is not widespread and that it has the largest impact on low-income earners. (The prevalence of any tax penalties would, of course, rise with more steeply graduated rates.) For the types of earners discussed above, though, income volatility is not widespread and does not generate large losses.[163]

As a threshold question of tax reform, therefore, the roughness of the justice meted out to the wealthy does not seem likely to generate widespread moral angst. Although there are instances in which averaging might change some outcomes, it is still possible to agree (which perhaps tempered enthusiasm) that "the annual period . . . seems roughly accurate for purposes of computing income."[164]

2. Averaging and Low-Income Earners

Rough justice is always roughest on the poor. Professor Lily Batchelder recently published a brilliant article analyzing the prevalence and consequences of income volatility, finding that it poses serious problems for significant numbers of low-income earners.[165] She concluded that a very limited system of income averaging would generate important benefits to the poorest members of our society.[166] It is for these taxpayers, rather than for the ultimately quite successful artists and inventors discussed above, that a careful change in policy would be most appropriate.

The combination of rising out of the zero bracket and losing eligibility for the Earned Income Tax Credit (EITC) creates a

[163] *See infra* Part IV.D.2.

[164] Schmalbeck, *supra* note 34, at 552.

[165] Batchelder, *supra* note 5.

[166] *Id.* at 421 et seq.

potential tax penalty of extremely large proportions for the working poor. Using 2001 rates, Batchelder compared a person earning $0 one year and $35,000 the next year with another earning $17,500 each year. The volatile earner would pay an average of $624 per year in taxes, while the steady earner would pay no income taxes. More significantly, the volatile earner loses an average of $3866 per year due to not being eligible for the EITC in either year. Her total loss is $8980.[167]

While that example was designed specifically to show the large amounts potentially at stake, Batchelder goes on to calculate that "[a]nnual income measurement increases the tax burden on poor taxpayers by an average of 2.0 percentage points compared to long-term income averaging — a tax penalty four times greater than that experienced by high-income families."[168] More bluntly, "[l]ow-income families do not . . . experience the same level of income volatility" as other taxpayers.[169] The relationship between income volatility and income, in fact, is negative.[170] This is a matter of real concern, at least for those who consider the alleviation of poverty to be a major tax policy goal.

In response to this limited but very important (and very solvable) problem, Batchelder proposes a system that she calls "Targeted Averaging," under which low-income earners would be eligible to take advantage of two very simple tools to reduce the tax penalty on their varying incomes: (1) averaging incomes for two years in calculating eligibility for the EITC, and (2) carrying back for one year unused standard deductions and personal and dependent exemptions.[171] Why limit the system to two years? Because most income volatility for the working poor dissipates quickly: "Three quarters of income volatility is gone after one year and nearly all after three to four years."[172] Batchelder suggests that although these data (which are at this point somewhat dated) might argue in favor of a three-year averaging system rather than a two-year system, the

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[167] *Id.* at 404.

[168] *Id.* at 397.

[169] *Id.* at 411.

[170] *Id.* at 415.

[171] *Id.* at 397.

[172] *Id.* at 423 (citing William T. Dickens, *The Growth of Earnings Instability in the U.S. Labor Market: Comments and Discussion*, *in* 2 BROOKINGS PAPERS ON ECON. ACTIVITY 262, 265 (1994), in turn citing Robert Moffitt & Peter Gottschalk, *Trends in the Covariance Structure of Earnings in the United States: 1969–1987*, 1001–93 (Inst. for Research on Poverty, Univ. of Wisconsin Discussion Paper, 1993)).

greater simplicity in calculations and record-keeping justifies the tradeoff.[173] Given that Targeted Averaging unavoidably makes the tax system somewhat more complex for lower income earners - for whom compliance burdens with the EITC are already a matter of legitimate concern - any reduction in additional complexity is a boon.

The difference between two and three years, though, is of only minor concern here. The more fundamental point is that Batchelder's system would involve a very small change in the tax system that would affect only a fraction of all taxpayers, whereas a general system of income averaging would affect all taxpayers and thus would be much more disruptive than Batchelder's plan. (Vickrey's full-scale plan to replace the current income tax system, of course, contemplates wholesale change in the entire code.) Targeted averaging, meanwhile, relieves a very real burden on the poorest workers, while more generally available income averaging would address purported horizontal inequities among the highly (if sometimes temporarily) affluent. While the problems posed by low-income volatility could potentially also be solved as part of a more general averaging system (though Vickrey does not focus on the issue), solving that problem by adopting a large-scale change to the tax system begins to resemble using a cannon to open a locked door.

It is possible, though, that the best argument for adopting Batchelder's plan is not based on income averaging at all. Is the motivation for such a plan our observation that some low-income people have it better than other low-income people, i.e., is this really about a failure to treat likes alike? This is where the revenue neutrality discussion has teeth, because it forces us to confront where we would come up with the money to fund the tax reductions and the EITC benefits that would flow to the poor volatile earners under Targeted Averaging.

If we are talking about system-wide revenue neutrality, the answer is very simple for anyone motivated by the concerns for the poor discussed above. If we can make low-income volatile earners better off without making low-income smooth earners worse off, that is an outcome that any advocate of progressive taxation could support. Funding the difference by taxing higher-income earners or through deficit spending seems easy to justify, especially since the aggregate amounts of money are likely to be relatively low.

Even if we for some reason required the Targeted Averaging system to be distributionally neutral, though, the change still seems

[173] *Id.*

well worth it. Shifting resources around among the poor would always feel awful, because those who end up losing net income can ill afford it. Even so, if it is necessary to push down the after-tax incomes of smooth income earners among the poor in order to prevent volatile earners from being hit with the kinds of penalties that Batchelder describes (and thus ending up in even more desperate straits than their poor compatriots), the difficult tradeoff would still be defensible.

Fortunately, of course we are not required to finance the Targeted Averaging system from the meager resources of the working poor. We should explicitly choose to finance averaging for the poor from the nonpoor.

3. Averaging and Middle-Income Earners

Having discussed averaging with respect to the high and low ends of the income spectrum, what of the middle? As noted above, Batchelder's analysis showed that the losses to the poor due to income fluctuations were larger than any other income class. She noted, though, that income volatility was negatively correlated with income, not that income volatility was limited entirely to the poor. If that is the case, perhaps averaging should be extended to the ranks of the middle class, or at least the lower middle class.

One argument against the extension of Targeted Averaging to the nonpoor is that the large majority of the loss suffered by the poor from the failure to average income is a loss in EITC benefits, not a penalty in taxes paid.[174] Middle-income earners do not qualify for the EITC, so the largest part of the gain from Targeted Averaging is irrelevant to them. Of course, middle-income earners pay more taxes than do poor earners (some of whom pay no federal income taxes at all), raising the stakes for middle-income earners.

In any case, there is no need to exclude everyone who is not officially poor from taking advantage of the tax aspects of Targeted Averaging. The official definitions of "poor" are, after all, by their nature arbitrary.[175] Just as there is reasonable room for debate over

[174] *See supra* note 167 and accompanying text (showing that less than one-fifth of the total loss for a poor taxpayer with volatile income is due to taxes paid, with the remainder due to lost EITC benefits).

[175] *See, e.g.*, Anna Bernasek, *A Poverty Line That's Out of Date and Out of Favor*, N.Y. TIMES, Mar. 12, 2006, § 3, at 6 (describing shortcomings with the traditional method of computing a federal poverty line and noting that a Census Bureau analysis for 2003 indicated that five million additional people would have been counted among the ranks of the impoverished under a computational method

whether the system should average incomes over two years or three years, we can agree that the upper limits of any system should be determined by looking at the data and seeing how many people will be helped by averaging, bearing in mind that expansion of the system carries with it administrative and other costs.

A different way to conceptualize the middle-income analysis is not by the numbers of people affected but by the categories of people who might be expected to display volatile incomes. In the analysis of high-income volatility above, the major focus of the analysis was not on how many people might benefit from averaging but on whether the professions most likely to experience volatile incomes were in some sense sympathetic enough to merit relief from an artifact of the annual tax system. While it proved difficult to find a sympathetic class of taxpayers there, perhaps the middle class provides more fertile ground.

One important source of income volatility for many middle-income families is not that a worker holds a job that exhibits uneven earnings patterns but that one member of the family moves into and out of the work force in different years. Most obviously, parents (usually mothers) who exit the labor force to care for children or other family members might well find themselves facing tax penalties compared to what they might pay if income taxes were based on multi-year averages. With a refundable system, such families could possibly receive income tax refunds during the years when their total incomes have dropped due to the mother's putting her job on hold. Such relief would certainly be welcome to such a family.

This situation seems sympathetic — certainly vastly more sympathetic than the actors, athletes, and artists discussed above. Perhaps surprisingly, though, even feminist theorists are split over whether it is a good idea to enact policies that make it easier for women to leave their jobs to provide care-giving services at home. Some argue that many families have two earners not because they want to have two earners, but because they simply cannot afford to have one parent stay at home.[176] If so, then we might want to enact policies making it a bit less expensive for families to trade income for parenting.[177]

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recommended by the National Academy of Sciences).

[176] *See generally* ELIZABETH WARREN & AMELIA WARREN TYAGI, THE TWO-INCOME TRAP: WHY MIDDLE-CLASS MOTHERS AND FATHERS ARE GOING BROKE (2003).

[177] Judith Warner, *The Parent Trap*, N.Y. TIMES, Feb. 8, 2006, at A21 ("We need . . . policies to promote part-time work options that don't force parents to forgo

On the other hand, Barbara Bergmann argues that it is a mistake to enable women to weaken their attachments to the labor market. With divorce and widowhood always a possibility, women's independence and financial survival crucially depend on being as employable as possible — and employability springs from having been regularly employed.[178]

Complicating matters further is the revenue neutrality question. If we are to pay for tax relief for this subset of middle-income earners by shifting the tax burden to higher-income earners, that is yet another way to shift the system toward more progressivity, though the political discussion of it would more likely focus on family values than tax progressivity. Whether there might be better ways to provide for child care expenses than through the tax code is, of course, also an important issue. Moreover, even if we use the tax code to provide benefits to parents, there are more direct ways to do so than by instituting an averaging system that does nothing to benefit parents who stay in the work force.[179]

If, on the other hand, we must pay for middle-class income averaging in a distributionally neutral way, then it implies that we would force those middle-class families who are not willing or able to have one parent leave the work force to pay higher taxes in order to provide tax relief to families that have been able to do so. There is no *a priori* reason to believe that that is (or is not) an appropriate reallocation of tax burdens. Clearly, these issues and myriad others like them must be hashed out in the political process.

The case for extending averaging to middle-income earners is, perhaps not surprisingly, inconclusive. There is no apparent reason to rule out averaging for all middle earners, nor is it necessary here to choose an income cutoff or a categorical limit on an averaging system. It is quite possible that a limited averaging system could be extended beyond the plan that Batchelder sketched out for poor workers. Choosing those limits, and deciding when and how to change those limits in response to changing social circumstances, goes beyond the scope of this article.

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benefits, fair pay and career prospects.").

[178] Barbara Bergmann, *The Only Ticket to Equality: Total Androgyny, Male Style*, 9 J. CONTEMP. LEGAL ISSUES 75 (1998).

[179] For example, the Child Tax Credit is a more direct tax subsidy for parents. *See* I.R.C. § 24.

V. SIMPLICITY, EFFICIENCY, AND INCOME AVERAGING

Even if we agree that there are no strong equity arguments in favor of income averaging (beyond the targeted plan that I advocate), it could be that adopting an averaging system for all taxpayers could nevertheless offer significant improvements in the simplicity of the tax system or in economic efficiency. If so, an averaging system could be preferred on nonnormative grounds. The analysis in this Part suggests, unfortunately, that an income averaging system would likely be very complicated (both in the public's perception of it and in its actual operation), while the efficiency effects are ambiguous and might even cut against the adoption of an averaging system.

A. Simple or Complicated?

Vickrey maintained throughout his life that his cumulative averaging system was a move toward simplification of the tax system.[180] Indeed, he seemed to view simplicity as an independent goal of his proposal, a virtue in itself in addition to progressivity.[181] One might even read him to be saying that progressivity is a secondary virtue of the system that can be compromised in the name of simplicity, as he referred to an "adequately progressive system" at the end of one of his articles.[182] Admittedly, this interpretation might put a bit too much emphasis on the word "adequately," because Vickrey otherwise seemed quite concerned with progressivity. Nevertheless, it is at least clear that he viewed simplicity as a great virtue of his plan.

How simple is the averaging aspect of Vickrey's plan? In his original article, Vickrey conceded: "Any averaging device will, of course, require a certain amount of record-keeping."[183] Nonetheless, "[t]he current records required under the present proposal consist of only four items: the year in which the taxpayer commenced to average, the adjusted total income, the total present value of past taxes, and the total value of the capital assets of the taxpayer declared

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[180] Note, for example, the title of one of his papers discussed here: *Tax Simplification Through Cumulative Averaging.* William Vickrey, *Tax Simplification Through Cumulative Averaging*, 34 LAW & CONTEMP. PROBS. 736 (1969).

[181] Vickrey, Level Playing Field 1995, *supra* note 12, at 1 ("Simplicity and progressivity can be realized . . . .").

[182] Vickrey, *After Thirty Years 1972*, *supra* note 12, at 133.

[183] Vickrey, *Averaging of Income 1939*, *supra* note 12, at 394.

on his latest return."[184] In his later work, Vickrey had honed down the administrative mechanism for such reporting:

> To simplify the processing of returns, it would be possible to attach to each return a coupon on which the taxpayer ID, the initial year of cumulation [sic], the cumulated income and the cumulated tax would be entered. This coupon could then be certified by the IRS and returned to the taxpayer for use in preparing his next year's return.[185]

1. Public Perceptions of Simplicity and Complexity

Despite his certainty that his system was simple — and his good faith attempts to improve its administrability — Vickrey's system was arguably really quite complicated. McCaffery, for example, says: "Despite Vickrey's frequent protestations to the contrary, the idea is complicated in practice."[186] Interestingly, McCaffery's description of what makes the cumulative averaging system complicated consists of simply describing the system. In substance, McCaffery's summary differs very little from what Vickrey described in claiming that the system is administratively simple:

> It entails choosing a certain period for smoothing, adding up cumulative income (or consumption) within the period, subtracting previously taxed income (or consumption) and then applying a rate structure, which could lead to negative taxes (refunds) as well as positive taxes (payments) in the immediate period of the return, depending on how this period fit with the average. Human events such as marriage, divorce, and death were subjects of some concern, and so on.[187]

To a substantial degree, therefore, what is simple might be merely a matter of taste. When Vickrey's eye beheld his creation, he saw its elegance and logical clarity. When McCaffery — and, to be completely clear, when I — look at the same system, we see something that hardly qualifies as simple. Perhaps more accurately, Vickrey's professional training and interests are likely to cause him to

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[184] *Id.*

[185] Vickrey, Level Playing Field 1995, *supra* note 12, at 5.

[186] Edward J. McCaffery, *A New Understanding of Tax*, 103 MICH. L. REV. 807, 880 (2005).

[187] *Id.*

think that "simple" need not mean "easy to understand," in the sense that the Quadratic Equation and the theory of relativity are simple in an elegant and even beautiful way. While this is a perfectly reasonable definition of simple, and even though it has the added advantage of distinguishing "simple" from "easy," simplicity is probably best understood – at least in the context of tax reform – not in the mathematical or analytical sense but in the on-the-street sense that a simple tax system is one that is easy to understand, easy to administer, and easy to obey.

For those of us with training in economic theory, though, it is easy to sympathize with Vickrey's apparent assumption that some things really *ought not* to be so difficult to understand. This assumption is nicely captured by one of the smaller topics in tax policy that Vickrey touched on in one of his final writings. Describing a policy that would promote greater efficiency in the market for parking automobiles in urban centers, Vickrey wrote:

> A more flexible and universal system of parking charges is needed whereby charges would be sufficiently high at times of greatest demand that a few reasonably convenient spaces would nearly always be available to those prepared to pay a market-clearing price, while charges would be reduced for times when demand is lower, being reduced to zero whenever there would be more empty spaces than is needed for convenience. Many technologies for doing this are available . . . .[188]

Viewed from a theoretical perspective, it is difficult not to nod and exclaim, "Q.E.D.!" for this is clearly a smart idea, one that is not even on the higher end of difficulty as economic concepts go. That this is likely to be viewed as extremely complicated (and potentially unfair) by the driving public seems secondary to the analytical simplicity of the system. Pushing the point further, Vickrey then adds: "More sophisticated systems are feasible that would permit the parking charge to be determined at the end of the parking occupancy at rates that could be varied according to how many nearby spaces have been vacant during the time of parking."[189] While Vickrey concedes that this is more "sophisticated," there is notably little if any concern for the perceptions of the public that would actually be subject to such a system. Instead, the focus is on first-best theoretical

[188] Vickrey, Level Playing Field 1995, *supra* note 12, at 22–23.

[189] *Id.* at 23.

outcomes: "If properly calibrated, this would automatically keep the charges at close to the market-clearing level, enhance efficiency and raise land values."[190]

My purpose here is clearly not to impugn Vickrey's motives or his mode of analysis as a useful step in the process of designing policies. Instead, my concern is that he lost sight of the concept of simplicity in the politically meaningful sense. Even if the system is "properly calibrated," will the public tolerate a system that is difficult to understand, to the point where it might not even be possible to know in advance how much it will cost to park? These uncertainties themselves could generate suspicion that the system is unfair, precisely because its complexity makes it difficult to determine with confidence whether the system is fair or not. Second, what if the rate is not properly calibrated? Can it be so improperly calibrated that the results would be worse than they are today? If so, how likely is such a gross miscalibration?[191]

Again, these arguments go only to the question of whether tax policies are likely to be viewed as simple in the pedestrian sense. When McCaffery says that Vickrey's cumulative averaging plan "is complicated in practice,"[192] he focuses on the question that seems to have frustrated Vickrey: Why was income averaging a nonstarter in the real world? Even if it is possible to have a system that is less of an administrative challenge than the income averaging system that we abandoned in 1986, the problem is that "simple" tax plans might not seem simple to the public at all.

I have, in fact, presented and argued in favor of simplified versions of Vickrey's cumulative averaging plan in appearances before a wide variety of audiences (noneconomics professors, students, journalists, etc.), and it is fair to say that none of the audiences came to embrace the plan or saw it as a way to simplify their tax-paying

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190 *Id.*

191 Admittedly, various forms of differential pricing have been tried (with regard to parking as well as other commodities, such as airline tickets), with varying degrees of success. The point of the analogy here, though, is to highlight how easy it is to design a system for its internal logic than for its acceptability to the public. Complications in determining airfares, for example, are a common complaint among customers; and attempts to complicate the pricing models still further meet with resistance. *See, e.g.*, Jeff Bailey & Christopher Elliott, *A Move to Add Still More Fine Print to Advertised Airfares*, N.Y. TIMES, Feb. 25, 2006, at C1 (quoting a travel analyst: "Buying an airfare is confusing enough now. This could make it even more confusing.").

192 McCaffery, *supra* note 186, at 880.

lives. Even after extensive question-and-answer periods, the reaction was most commonly along the following lines: "Seems kind of complicated." "Is that really any better than the current system?" "No one will understand this." While this is hardly definitive proof that it would be impossible to educate the public to accept an averaging plan, it at least suggests that the hurdles to acceptance are greater than Vickrey seemed to believe. These experiences did, in any case, contribute to my change in position from being an advocate of cumulative averaging to being a reluctant critic.

2. Simplicity in Tax Planning

Whether or not the public could be convinced that an income averaging system is "simple," there might still be some simplicity advantages in setting up a system that provides fewer tax planning opportunities. Indeed, as noted above, Vickrey believed that averaging would be advantageous largely because of the simplification provided by the elimination of timing advantages, with interest being charged on tax liabilities from the date the income is earned, even though the tax plus interest would not be paid until realized.[193] Even for earned income, moreover, averaging over long periods of time requires the computation of interest using a rate that would be set by policy makers.[194]

Even assuming away the complications that would come with including interest rate calculations in the computation of tax liabilities, Vickrey's suggestion that the interest rate charged on unpaid taxes could be varied as a macroeconomic policy lever opens up an entirely new area for planning and lobbying opportunities.[195] The availability of the tax system's interest rate as a policy lever would become an irresistible magnet for lobbying. The more the tax system's interest rate is used as a policy lever, of course, the less the interest rate

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[193] Vickrey, Level Playing Field 1995, *supra* note 12, at 5–6.

[194] Fennell and Stark describe the necessary steps as follows:

> Under Vickrey's approach, taxpayers would, in effect, keep a lifetime tally of both their cumulative income and the taxes paid on that income in previous years. After adjusting these figures to include an interest component on taxes paid in previous years, the taxpayer would then calculate his tax liability on his new adjusted cumulated income, subtracting the present value of previous taxes paid to derive the current year's tax liability.

Fennell & Stark, *supra* note 67, at 25.

[195] Vickrey, Level Playing Field 1995, *supra* note 12, at 6.

adjustments in an averaging system would comport with reality. Taxpayers would not be neutral about the timing of their income and taxes, because the interest rates that they would pay on loans and receive on deposits would not be reliably connected to the interest rate used in the tax averaging system.

Arguably, of course, there could still be a net advantage from averaging, because whereas we now charge zero interest on unrealized gains, we would at least be charging some positive interest rate on unpaid taxes — although Congress could certainly set the rate at zero if it chose. This could reduce the net financial advantage, causing at least some marginal tax planning to cease. Even so, there is always the possibility that Congress could change the interest rate (even retroactively), making it important for sophisticated taxpayers to plan around possible changes in the tax system's interest rate.

In other words, even if we joined Vickrey in believing that averaging at least "gets it right" by looking at income over time, it is not necessarily true that being right in this way will decrease tax planning. By analogy, consider the concept of depreciation. Under an income tax, it is clearly important to allow taxpayers to take into account the losses in their net worth that arise from the decrease in the value of their assets. Allowing no depreciation deduction would get it clearly wrong, and so would immediate expensing.

While it would certainly be wrong not to allow depreciation in an income tax system, our experiences with accounting for depreciation do not inspire confidence that attempting to get it right will bring about reductions in tax planning and lobbying. The allowance for depreciation through the Accelerated Cost Recovery System[196] is most definitely not an exercise in "getting it right." The system instead creates formulae that do not reflect the useful economic life of assets and which have the effect of "bunch[ing] the deductions in the early years of the use of the machine."[197] The system is hardly simple, and it has been modified in rather radical ways on numerous occasions.[198] While the system of depreciation was brought into existence in an effort to measure income correctly, it has not made the tax law simpler or reduced lobbying and planning opportunities.[199]

In short, the adoption of averaging would not reliably reduce planning opportunities. In fact, the introduction of the interest rate

196 *See* I.R.C. §§ 167–168.

197 WILLIAM A. KLEIN ET AL., FEDERAL INCOME TAXATION 28 (14th ed. 2006).

198 *Id.* at 548.

199 *See generally id.* at 544–50.

on unpaid taxes as a controllable policy lever would introduce a new variable into tax planning equations. Enterprising politicians would quickly recognize that there are ways to provide tax advantages through the system, and tax planners would be almost certain to anticipate and take advantage of the resulting complexity.

3. Messy Design Choices

To this point, the discussion has been based on the "simple" core of the income averaging system. In addition to the basic design, there are additional real-world complexities that will inevitably bedevil any attempt to design an averaging system for the United States (or any other country). What are these other issues that would multiply the potential complexities in an averaging system? An example or two will illustrate the range of issues at stake.

One important question is how to define the averaging period. If any specific number of years is unacceptably arbitrary, presumably we must truly mean "lifetime" averaging.[200] Does that mean that we measure income from birth? This raises the question of whether it is fair to tax one eighteen-year-old who earned $5,000 per year from age nine onward the same as another who earns nothing until they earn $50,000 at age eighteen. If, on the other hand, the averaging period begins upon the initial receipt of income, this could encourage parents to make sure that their children earn some nominal amount of income during childhood, simply to increase the number of years over which income can be averaged. The question might seem narrow, but it is likely to affect many more people than the artists, athletes, and authors discussed above.

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[200] Of course, even a lifetime is arbitrary. If a taxpayer cares about—and makes earning and consumption decisions by taking into account—the well-being of her current and future heirs, why stop at death? Should parents' incomes be averaged into the incomes of their children and children's children? Because children and parents typically have overlapping earnings lifetimes, the logic of income averaging would seem to have plausible application not just to the choice of tax period but also to the choice of taxable unit. The two dimensions (how many people to tax as a single unit, and how many years to aggregate in setting income tax liabilities) could interact in profound ways that are far beyond the scope of this article. I make this point not to trivialize the averaging issue through *reductio ad absurdum* but rather to point out that the analysis in this paper presents something of a false choice: it is not a matter of choosing between taxing a person on their income for one year or for a longer period of time, perhaps as long as their entire life. The time periods can be longer, and the complexity of the taxable unit can rise almost without limit.

Similarly, the definition of retirement becomes a potential stumbling block. How do we prevent the refundable averaging system from becoming another retirement benefit plan? Do we require that a person be working full time in order to benefit from averaging? Does that apply to people mid-career, even when their part-time status is not necessarily their choice? To each of these questions there can be answers, but none of them are obvious from the theory of averaging.

Furthermore, Vickrey's system raises the stakes for those who would challenge their tax assessments. If a person's tax liability is determined by all past income, should they be able to challenge their income determinations for every year in the averaging period? Would a tax year ever be closed? An arbitrary statute of limitations on tax challenges (such as three years) could be imposed, of course, with the equity concern that a person might not have known of the importance of challenging a tax determination until after the statute has lapsed. On a practical level, if both the taxpayer and the Internal Revenue Service (Service) lose the ability to contest results after three years, while legally-binding facts from more than three years ago are used in subsequent tax computations, this would create an added incentive to contest or litigate close calls to guard against losing the right to challenge facts that currently might seem too minor to challenge.

These thumbnail sketches are obviously meant only to be suggestive, pointing out that real-world implementation issues unique to (or heightened by) an averaging system could be quite challenging. Other issues surely lurk, but even these brief descriptions demonstrate that averaging raises more perplexing issues than might initially be obvious.

It should be noted, though, that these complexity issues are very closely tied to how ambitious we would be in adopting an averaging system. A lifetime cumulative averaging system all but requires the introduction of interest rate adjustments in the system, whereas a two- or three-year averaging system would not be fatally compromised if interest adjustments were not allowed. Moreover, Batchelder's Targeted Averaging plan is limited to a relatively small group of taxpayers, and many of the confusing aspects of the proposal go away when taxpayers only have to take into account one or two previous years of income and tax information.

Therefore, while the inevitable complexity of averaging can be daunting, large amounts of that complexity can be eliminated by adopting Targeted Averaging. Adoption of any averaging plan will create some complexity, of course; but the benefits of Targeted Averaging to the poor appear to make those costs worth bearing. The normative case for Targeted Averaging is compelling, and it appears not to fail the test of simplicity.

B. Efficiency

The possibility of gains in economic efficiency raises the prospect that a system of income averaging might be a wise policy choice notwithstanding its weaknesses on equity and simplicity fronts. It turns out, though, that the efficiency effects of adopting an averaging system are hard even to conceptualize, much less measure. After a very brief description of standard efficiency analysis, this Part will conclude with a discussion of a less well-known theory, known as winner-take-all markets, that suggests that lowering tax rates on high-income occupations could have negative efficiency effects.

1. Standard Efficiency Analysis

Fennell and Stark provide a short but very nice summary of the efficiency effects of a system of lifetime averaging.[201] It is unnecessary to list here the various issues that they raise, but one example should provide the flavor of the analysis. Over time, they note, volatile income earners face a variety of marginal tax rates; and an income averaging system would replace those rates with a single marginal rate. "Because higher marginal tax rates create disproportionately larger distortions, this shift would be expected to increase efficiency."[202] Moreover, the choice of career might be distorted by facing a higher tax rate on incomes earned in careers with volatile earnings patterns, causing people to choose careers that they might not otherwise prefer.[203]

There are, however, also considerations that suggest that averaging might reduce economic efficiency, because "if some portions of the life cycle feature more elastic labor supply or different proportions of marginal and inframarginal taxpayers, lifetime averaging would be unable to exploit those differences."[204] Liebman also provides analyses that cut both ways, finding that — even in a simplified model where taxpayers are "present-focused" — the results of the efficiency analysis are ambiguous. "Liebman's analysis suggests that the desirability of income averaging from an efficiency

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201 Fennell & Stark, *supra* note 67, at 28–32.

202 *Id.* at 28–29.

203 *Id.* at 29.

204 *Id.*

perspective depends, at least in part, on the relative proportions of the population that experience flat, upward-tending, and downward-tending income profiles."[205]

The efficiency analysis is also affected by the revenue neutrality assumption. If the adoption of an averaging system requires higher rates on all taxpayers, then any gain in efficiency to taxpayers who are advantaged by the averaging system would be offset by distortions from higher rates.

This brief summary of a few standard efficiency considerations is obviously unlikely to satisfy those with an interest in such analysis. (Those readers should refer to Liebman's working paper.) For present purposes, though, the point is that standard efficiency analysis does not reach a clear verdict on whether income averaging is likely to increase or decrease economic efficiency. At best, the case for adopting an averaging system would have to await empirical evidence that might find a net positive effect on efficiency. Until then, however, standard efficiency analysis does not strengthen (nor weaken) the case for adopting a system of income averaging.

2. Efficiency and Winner-Take-All Theory

A recent argument that ties efficiency concerns to tax progressivity relies on a relatively new theory known as "winner-take-all" analysis.[206] The basic idea is that the increasing spread between the enormous rewards to the favored few in a small number of high-profile positions (including CEOs, as well as actors, musicians, etc.) and the shrinking rewards to the unlucky majority creates an efficiency loss for the economy. This view focuses on the choices that people must make in how to spend their time and talents during their lifetimes. If there is an ever-widening spread between the rewards for pursuing different activities, more people will be increasingly tempted to compete for the shrinking number of high-paying jobs — leaving behind economically important but less extraordinarily well-paid jobs. Such people, without consideration of the effects of their decisions on the overall economy, then misallocate their talents and waste valuable

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[205] *Id.* at 31.

[206] ROBERT H. FRANK & PHILIP J. COOK, THE WINNER-TAKE-ALL SOCIETY: HOW MORE AND MORE AMERICANS COMPETE FOR EVER FEWER AND BIGGER PRIZES, ENCOURAGING ECONOMIC WASTE, INCOME INEQUALITY, AND AN IMPOVERISHED CULTURAL LIFE (1995); *see also* Martin J. McMahon & Alice G. Abreu, *Winner-Take-All Markets: Easing the Case for Progressive Taxation*, 4 FLA. TAX REV. 1 (1998).

resources in an effort to gain every advantage possible in the crowded markets for glamorous jobs.[207]

The net result is that the overall labor force is less productive than it would otherwise be, and resources are wasted in pursuit of high-paying professions. This is in direct contrast to the standard notion that high pay is necessary to get people to work hard (i.e., to be productive) and to be willing to work in highly paid and highly productive professions. It is possible, in fact, that the extra hard work associated with attempts to enter these "winner-take-all" markets is not productive work at all — even assuming that it is always possible for people to raise their marginal effort.

One policy that this analysis suggests is, obviously, progressive taxation. Anything that narrows the spread between the highest paid (net of taxes) and the lowest paid will reduce (but not eliminate) the wasteful competition to reach the higher ends of the pay spectrum. This is not, however, an argument only for higher taxes, because the effect is only seen at the high end of the earnings curve. Winner-take-all analysis suggests, if anything, that the taxes on mundane jobs might even be reduced at the same time that taxes on the highest incomes are raised, because a larger difference in the tax rates will reduce the temptation for people to waste their talents aiming for the most lucrative jobs.

The source of the inefficiency in this analysis is that too many people are spending time and effort trying to enter professions for which they will never quite qualify. If winner-take-all theory is correct, and if the labor provided by potential workers in the highest paid jobs is at all elastic, then there should be a shift whereby workers spend less time in futile attempts to gain glamorous jobs and instead work toward improving their skills to prepare for more achievable jobs. Since the number of glamorous jobs is limited (the total numbers of players on professional basketball rosters, for example, being a set number), this would mean that we would end up with just as many people in the glamour jobs and everyone else having more productively spent their time on achievable goals.

In short, the efficiency story regarding income averaging is murky at best, but the addition of winner-take-all considerations to the mix adds one more reason to suspect that raising taxes on the highest income earners could have beneficial economic effects. Such effects might ultimately be overwhelmed in a definitive empirical test of the overall behavioral implications of adopting a system of income

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[207] FRANK & COOK, *supra* note 206, at 8.

averaging. Until such a test is completed, though, the efficiency analysis does little to counterbalance the negative conclusions from the equity and simplicity analyses above. The case for income averaging on all counts thus appears to be very weak, except at lower income levels.

Notably, the efficiency case does not become less murky when we confine ourselves to the more limited averaging system that I have advocated above. Unlike the discussion regarding simplicity, the Targeted Averaging plan does not appear to be more amenable to clear-cut efficiency analysis than a more general averaging plan. The conclusions above regarding the lack of appeal of a large-scale averaging system and the appeal of a Targeted Averaging system are neither strengthened nor weakened by efficiency analysis.

C. Macroeconomic Implications

Although it is beyond the scope of this article, it is also worth noting that a nonequity-based argument can be made in favor of income averaging from a macroeconomic perspective. Specifically, the refundable nature of a Vickrey-like system of cumulative taxation would guarantee that, in the event of an economic downturn, taxpayers would receive refunds of previously paid taxes. This would have the effect of being an enhanced "automatic stabilizer," which is a feature of the fiscal system that — without intervention by Congress during a business cycle — will tend to reduce the severity of swings in the economy. The income tax itself is an automatic stabilizer, because it "cuts taxes" when incomes fall during a recession. A refundable averaging system would not merely reduce tax collections but would have the government giving taxpayers refunds, which they could then spend.

The effects of the refundable averaging system on macroeconomic outcomes would also include changes in the size of the "fiscal multipliers," which determine the ultimate size of the change in national income due to a change in policy. Such considerations could well turn out to be an independent source of support for adopting an averaging system.

VI. CONCLUSION

This article has analyzed the idea of replacing our current annual system of tax assessment with a system that bases tax assessments on income averaged over the space of years or even a lifetime. After summarizing the fundamental goals of tax reform, especially with regard to the equity issues raised by income averaging, I examined whether adopting any system of income averaging that would be available to all taxpayers (including, but certainly not limited to, William Vickrey's full-scale cumulative averaging system) would achieve a compelling change in the fairness of the tax system. While the current system creates a possible problem of horizontal inequity in that people with similar lifetime incomes can pay different tax rates based on the timing of those incomes, there is a serious question whether — when taking all circumstances into account — such differences are really horizontal inequities at all. In any case, my analysis suggests that tax reform should be based on vertical equity concerns, not horizontal concerns.

Even if the differences in tax treatment for those with volatile incomes are seen as inequities, those inequities as they apply to higher-income earners are ultimately not compelling enough to justify a restructuring of the U.S. tax system that would allow income averaging for all taxpayers. The poor (and perhaps the lower reaches of the middle class), however, are uniquely burdened by the volatile nature of their income streams. I therefore endorse a plan recently offered by Lily Batchelder to allow lower-income people to smooth their incomes in order to avoid a loss of tax benefits. This plan has the distinct advantage of not requiring a broad restructuring of the tax system, providing targeted relief to the neediest Americans through minimal legislative intervention.

In addition to the normative analysis of income averaging plans, I also analyzed the possibility that averaging systems might be worth adopting on the basis of improving the simplicity or efficiency of the tax system. I concluded that a broad-based income averaging plan is likely to be viewed as quite complicated; and only the very limited system aimed at the poor and near-poor that I advocate would be sufficiently uncomplicated to justify adoption — especially when those minimized complexity costs are weighed against the equity gains for lower-income taxpayers. The efficiency analysis, by contrast, provides no clear guidance either way, although so-called "winner-take-all" analysis suggests at least one reason to deny to high-income earners the advantages of income averaging.

In short, this article has argued that income averaging does have a valuable role to play in achieving better normative outcomes for the tax system and society as a whole; but that role should be very limited and apply only to lower-income workers. A systemic change toward taxing average income rather than annual income appears to be unjustified on the grounds of equity, simplicity, or efficiency.